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WM R. STANSBURY
CLERK

Supreme Court of the United States

OCTOBER TERM, 1925.

No. 258.

GEORGE D. PROVOST and CORNELIUS W.
PROVOST, copartners, composing the firm of
PROVOST BROS. & CO.,

Appellants,

—against—

THE UNITED STATES.

Brief on Behalf of Appellants.

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10

SUBJECT INDEX.

	Page
Statement of Nature of Case	1
Text of Law	1
Text of Treasury Decision 2685	3
Text of Proviso in Revenue Act of 1921	5
Statement of Facts	5
Holding of the Court of Claims	16
Appellants' Contentions	17
 Point I. The history of similar legislation indicates clearly that it was not the intent of Congress to tax the borrowing and return of stock among brokers	 18
A. Earlier taxing acts similar in language and purpose were held not to apply to such transactions	18
B. The reenactment in the 1918 Act of the Stamp Tax provisions of the 1917 Act, does not indicate a ratification by Congress of the Treasury Department's ruling.....	26
C. The Revenue Act of 1921 contains an express declaration disapproving the Treasury Department's interpretation of the 1917 and 1918 Acts	37
 Point II. There is no ground for inferring that Congress intended to discriminate against short sales or to impose a greater tax on "short" than on "long" transactions, nor is there any ground for assuming that Congress knew of the practice of brokers to borrow and return stocks in connection with short sales and intended to tax such borrowing and return	 43
A. A short sale is merely a sale for future delivery, and borrowing of stock is not essential to its execution. The custom of bor- rowing stock incident thereto is merely one of convenience among brokers, adopted to facilitate trading on the floor of the Stock Exchange. There is nothing to indicate that Congress was cognizant of this custom or intended to tax such trans- actions	44
B. There is no ground for assuming that Congress intended to impose a greater tax upon short transactions than that imposed upon long transactions. Short selling has been repeatedly found to be a beneficial and not a detrimental practice.....	48
C. There is nothing peculiarly speculative about a short sale, which justifies the imposition of a prohibitive or discriminatory tax	55
(a) As between the brokers who alone are parties to the borrowing and return of stock, the transaction is not speculative	56
(b) With respect to the customer, the speculative nature of the transaction is not created or enhanced by the borrow- ing and return of the stock	57
(c) "Short" selling is no more speculative than "long" buying	58

	Page
D. Congress, not having expressed a clear intent to tax the lending of stocks and their return, the holding of the Court of Claims violates the well settled principle that a taxing act will not be extended by implication	60
Point III. The transactions involved in this claim are not taxable under the enacting clauses of the 1917 and 1918 Acts	65
A. The word "deliveries" as used in the 1917 and 1918 Acts, cannot be held to apply to every transfer of physical possession. It must be construed in the light of its context, and as so construed must be limited to sales and other similar transfers of legal title	66
B. The lending of stock, as practiced by brokers, does not constitute a transfer of legal title. The relation between the lending broker and borrowing broker is that of pledgor and pledgee. The transaction being a pledge, there is no transfer of title....	75
C. The opinion of the Attorney General, upon which Treasury Decision 2685 was based, was rendered without a complete understanding of the facts and was based upon an erroneous assumption of the facts and a misapprehension of the law applicable to the transactions in question	98
Point IV. The lending of stock is equivalent to the deposit of stock as collateral security for money loaned thereon and is, therefore, exempt from tax under the first proviso of paragraph IV of Schedule A	104
Conclusions	115
Appendix	117
Extract from "The Work of the Stock Exchange," by J. Edward Meeker	117
Extract from "The Stock Market," by Solomon S. Huebner.....	122
Extract from "The Stock Exchange from Within," by William C. Van Antwerp	125

TABLE OF CASES.

	Page
Atkins v. Gamble, 42 Cal. 86	92
Bailey v. Clarke, 21 Wall. 284	41
Barclay v. Culver, 30 Hun (N. Y.) 1	103
Bonbright & Co. v. State of New York, 165 App. Div. (N. Y.) 640....	63
Bond v. Hume, 243 U. S. 15	53
Casey v. Sterling Cider Co., 294 Fed. 426.....	32
Caswell v. Putnam, 120 N. Y. 153	94
Chambers v. McCreery, 98 Fed. 783	87
Clews v. Jamieson, 182 U. S. 461	52
Cope v. Cope, 137 U. S. 682	40
Copper Queen Mining Co. v. Arizona Board, 206 U. S. 474	24
Cotton v. James, 1 Moody & Malkin, 273	73
Day v. Morristown, 62 N. J. L. 571	74
Douglas v. Carpenter, 17 App. Div. (N. Y.) 329	94
Dykers v. Allen, 7 Hill 497	103
Emmons v. Lewistown, 132 Ill. 380	74
First National Bank v. Lanier, 11 Wall. 369	81
Fosdick v. Greene, 27 Ohio St. 484	103
Gorman v. Littlefield, 229 U. S. 19	101
Gould v. Gould, 245 U. S. 151	61
Hindry v. Holt, 24 Colo. 464	74
Holy Trinity Church v. United States, 143 U. S. 457	68
International Trust Co. v. American Loan & Trust Co., 62 Minn. 501.	72
Iowa v. McFarland, 110 U. S. 471	87
Irwin v. Williar, 110 U. S. 499	52
Isitt v. Beeston, L. R. 4 Exch. 159	73
Karasek v. Peier, 22 Wash. 419	75
Knox v. Eden Musee Co., 148 N. Y. 441	80
Komada & Co. v. United States, 215 U. S. 392	28
Mackall v. District of Columbia, 16 App. Cas. (D. C.) 301	73
Markham v. Jaudon, 41 N. Y. 235	101
Matter of Mills, 139 App. Div. (N. Y.) 55	47
Matter of Mills, 125 App. Div. (N. Y.) 730	83, 97
Mayer v. Monzo, 151 App. Div. (N. Y.) 866	101
McNeil v. Tenth National Bank, 46 N. Y. 325	79
McDonald v. Hovey, 110 U. S. 619	25
Merritt v. Cameron, 137 U. S. 542	31
National Lead Co. v. United States, 252 U. S. 140	25
National Safe Deposit Savings & Trust Co. v. Hibbs, 229 U. S. 391	81
New Haven Railroad Co. v. Interstate Commerce Commission, 200 U. S. 361	28, 29
Payne v. Gardiner, 29 N. Y. 146	99
People v. New York & Manhattan Beach Ry. Co., 84 N. Y. 565.....	71
Pereria v. Wallace, 129 Cal. 397	74
Richardson v. Shaw, 209 U. S. 365	90, 101
Sexton v. Kessler, 225 U. S. 90	83
Skiff v. Stoddard, 63 Conn. 216	91
State v. Walsh, 43 Minn. 444	67, 74
Strickland v. Magoun, 119 App. Div. (N. Y.) 113	101
Thomas v. Lewis, 89 Va. 1	74
Tiger v. Western Investment Co., 221 U. S. 286	42
Thomas v. Vandegrift & Co., 162 Fed. 645	36
Tompkins v. Morton Trust Co., 91 App. Div. (N. Y.) 274	83
Travis v. American Cities Co., 192 App. Div. (N. Y.) 16	62
Travis v. Ann Arbor Co., 180 App. Div. (N. Y.) 799	63
United States v. Allen, 179 Fed. 13	35

United States v. Cerecedo Hermanos y Compania, 209 U. S. 337	24
United States v. Falk & Bro., 204 U. S. 143	28, 29
United States v. Field, 255 U. S. 257	60
United States v. Freeman, 3 How. 556	41
United States v. Healey, 116 U. S. 136	30
United States v. Merriam, 263 U. S. 179	61
United States v. Philbrick, 120 U. S. 52	28
United States v. Standard Brewery, Inc., 251 U. S. 210	72
Virginia v. Tennessee, 148 U. S. 503	70
Wood Mowing & Reaping Machine Co. v. Van Story, 171 Fed. 378	88

Supreme Court of the United States.

GEORGE D. PROVOST and CORNELIUS
W. PROVOST, copartners, compos-
ing the firm of PROVOST BROS.
& Co.,

Appellants,

v.

THE UNITED STATES.

October
Term, 1925.
No. 258.

BRIEF ON BEHALF OF APPELLANTS.

This is an appeal from a judgment of the Court of Claims, dismissing the claim on the merits. Booth, J., delivered the opinion of the Court, which is printed on pages 12 ff. of the record.

This case involves the construction of the Revenue Act of 1917 and of the Revenue Act of 1918, with respect to those provisions of both acts which imposed a stamp tax upon transfers of stock. The question is whether or not the provisions of those laws (which are in substantially the same language in this respect) imposed such tax upon the lending of stocks and the return of borrowed stocks among stock-brokers incident to transactions known as "short sales."

THE LAW.

Paragraph 4 of Schedule A of Title VIII of the Act known as the War Tax Law or War Revenue Act, approved October 3, 1917, imposed a tax as follows:

"4. Capital stock, sales or transfers: On all sales,
or agreements to sell, or memoranda of sales or deliv-

eries of, or transfers of legal title to shares or certificates of stock in any association, company, or corporation, whether made upon or shown by the books of the association, company, or corporation, by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock or not, on each \$100 of face value or fraction thereof, 2 cents, and where such shares of stock are without par value, the tax shall be 2 cents on the transfer or sale or agreement to sell on each share, unless the actual value thereof is in excess of \$100 per share, in which case the tax shall be 2 cents on each \$100 of actual value or fraction thereof: *Provided*, That it is not intended by this title to impose a tax upon an agreement evidencing a deposit of stock certificates as collateral security for money loaned thereon, which stock certificates are not actually sold, nor upon such stock certificates so deposited: *Provided further*, That the tax shall not be imposed upon deliveries or transfers to a broker for sale, nor upon deliveries or transfers by a broker to a customer for whom and upon whose order he has purchased same, but such deliveries or transfers shall be accompanied by a certificate setting forth the facts: *Provided further*, That in case of sale where the evidence of transfer is shown only by the books of the company the stamp shall be placed upon such books; and where the change of ownership is by transfer of the certificate the stamp shall be placed upon the certificate; and in cases of an agreement to sell or where the transfer is by delivery of the certificate assigned in blank there shall be made and delivered by the seller to the buyer a bill or memorandum of such sale, to which the stamp shall be affixed; and every bill or memorandum of sale or agreement to sell before mentioned shall show the date thereof, the name of the seller, the amount of the sale, and the matter or thing to which it refers.

Any person or persons liable to pay the tax as herein provided, or anyone who acts in the matter as agent or broker for such person or persons who shall make any such sale, or who shall in pursuance of any such sale deliver any stock or evidence of the sale of any stock or bill or memorandum thereof, as herein required, without having the proper stamps affixed thereto, with intent to evade the foregoing provisions shall be deemed guilty of a misdemeanor, and upon conviction thereof shall pay a fine of not exceeding \$1,000, or be imprisoned not more than six months, or both, at the discretion of the court."

A similar tax was imposed by paragraph 4 of Schedule A of Article XI of the Revenue Act of 1918, approved February 24, 1919. We need not burden the Court with a recital of the provisions of this Act. They were substantially similar to those of the 1917 Act, and will be set forth at a later point in this brief.

On March 30th, 1918, the Commissioner of Internal Revenue issued Treasury Decision 2685 as follows:

"Treasury Department,
Office of Commissioner of Internal Revenue,
Washington, D. C.

To Collectors of Internal Revenue and others concerned:

In accordance with an opinion from the Attorney General, dated March 23, 1918, it is held that the transfer of shares or certificates of stock in any association, company, or corporation made by the person loaning stock to another borrowing the stock to effect a sale, and also the transfer of shares or certificates of stock from a borrower returning them to a lender in fulfillment of the borrower's obligation to buy in and return stock, are both subject to the tax imposed by Sections 800 and 807,

Schedule A, subdivision 4, Title VIII, of the war-revenue act of October 3, 1917. In a so-called short-sale transaction there are, therefore, four taxable sales or transfers: (1) The sale of stock by the person making the short sale; (2) the transfer from the lender of stock to the person making the short sale, so that he may make delivery of the stock sold; (3) the purchase by the borrower of stock to return to the lender; (4) the transfer from the borrower to the lender of shares to replace those borrowed.

Daniel C. Roper,
Commissioner of Internal Revenue.

Approved March 30, 1918;
W. G. McAdoo,
Secretary of the Treasury."

This action, briefly stated, involves the question of the correctness of the foregoing Treasury Decision with respect to items "(2)" and "(4)." No question is raised as to items "(1)" and "(3)."

Following the publication of the foregoing ruling, the claimants, a firm of stock brokers, were required to purchase and cancel stamps in connection with the lending of stocks to other brokers and in connection with the return to other brokers of stocks previously borrowed by claimants. The period covered by the stamps so required to be purchased and cancelled was from December 1, 1917, when Title VIII of the War Tax Law took effect, to December 31, 1921, inclusive—the present claim, however, is limited to stamps affixed and cancelled prior to June 1, 1920. On January 1, 1922, the Revenue Act of 1921, became effective, and the doubt (hereafter referred to) as to whether loans of stock and the return of loaned stock were taxable—which doubt had existed on the part of the officials charged with the enforcement of the Revenue Laws—was removed by the ex-

press proviso contained in Paragraph 3 of Schedule A of Title XI of the Revenue Act of 1921, reading as follows:

"Provided, That it is not intended by this title to impose a tax upon an agreement evidencing a deposit of certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon the delivery or transfer for such purpose of certificates so deposited, nor upon mere loans of stock nor upon the return of stock so loaned." (Italics ours.)

THE FACTS.

The facts were stipulated and, as so stipulated, were adopted by the Court of Claims as its Findings of Fact.

The claimants are stockbrokers doing business in the City of New York, under the firm name of Provost Bros. & Co. One of the claimants, Cornelius W. Provost, is a member of the New York Stock Exchange.

As part of the business of the claimants, they from time to time loaned stocks to other brokers, and, having likewise from time to time borrowed stocks from other brokers, they from time to time returned such borrowed stocks. Both upon the lending of stocks and the return of borrowed stocks, claimants affixed to the proper documents Federal Stock Transfer Stamps at the rate of 2 cents for each share so loaned or returned during the period of time covered by this claim, to wit, from December 1, 1917, to May 31, 1920. The aggregate amount of stamps affixed and cancelled in the case of stocks loaned was \$134. The aggregate amount of stamps affixed and cancelled in the case of borrowed stocks returned was \$3,210.76, making a total amount claimed herein of \$3,344.76 (Finding of Fact XXII; R. 10).

Before referring in detail to the circumstances which operated to compel the claimants to affix and cancel the stamps referred to, it might be well to indicate briefly the various operations of the brokers which led to the lending and borrowing of stocks among them.

From one aspect of the case the lending and borrowing of stocks are incident to the consummation of short sales. By a short sale of stock is meant a sale or contract for the sale of stock which the seller does not deliver to the broker who is employed to make the sale (Finding of Fact III; R. 6). When a customer (whom we will call "A") of a stockbroker (whom we will call "B") orders the said broker B to sell a number of shares of a certain stock which he does not immediately deliver to B, and which are not "long" in the customer's (A's) account, the sale is known as a short sale. A's order to sell does not necessarily imply that A does not own or control the stock which he directs to be sold for his account. The stock may be in A's safe deposit box in some distant city or country to which he may not be able to have access for some time; it may be pledged with a bank from which he does not find it convenient to redeem the stock at that time; it may not be in deliverable condition because of the absence of a person whose endorsement is required. There may be any number of reasons why A cannot conveniently deliver the stock to B to consummate the sale. Ordinarily, however, A does not own the stock, and he intends to make a delivery in the future by purchasing it in the open market, which he hopes to be able to do at a lower price, and thereby make a profit. The broker B may not know the reason why the stock is not delivered by his customer A, and unless A informs B, B will not know whether the stock is not immediately available to A or whether he expects to be able to procure it at a lower price at some later time. A's motive is of no interest to B, and in either case the sale is treated as a "short sale" and the order is handled accordingly.

B, upon proper margin given by A, executes this order to sell on the floor of the Stock Exchange in the "regular way," by selling to another broker (whom we will call "C") the specified number of shares of the specified stock. So far as the sale by B to C is concerned, the sale is the same as any other sale. There are no characteristics which distinguish it from a sale of stock which A actually owns and which he

is ready and able to deliver. The selling broker B delivers to the purchasing broker C a "sales ticket," which is a memorandum of the sale, to which are affixed and cancelled Federal stock transfer stamps, as required by the provisions of the Revenue Acts of 1917 and 1918 above referred to (Finding of Fact V; R. 6). (No claim is made by the claimants with respect to the stamps so affixed to "sales tickets," for, concededly, the transfer of stock to effect a short sale is precisely the same as the transfer of stock where the sale is a sale of stock actually owned by the seller and delivered in the customary manner.)

Under the rules of the New York Stock Exchange (as well as the custom among brokers generally) delivery of stock when sold by one broker to another, unless otherwise agreed, is required to be made on the following business day (Finding of Fact VI; R. 6).

Since delivery must ordinarily be made on the following day, it is customary for broker B when he executes an order for a short sale, to borrow similar stock in order to make delivery, as required by the rule. Broker B, accordingly, borrows the stock from a third broker (whom we will call "X") and makes delivery to C as required by the rule (Finding of Fact VII; R. 6). This completes the transaction so far as the sale by B (acting as broker for A) is concerned.

When the loan of stock from X to B takes place, a "loan ticket" is delivered by X to B. The stamps which are the subject matter of this claim were, in part, affixed to such loan tickets.

The borrowing of stock by a selling broker in order to make delivery to the purchasing broker is, therefore, the distinguishing characteristic of the short sale so far as the selling broker is concerned. The sale having been completed so far by delivery of the stock to the purchasing broker C, the latter is no longer concerned therein.

At the time of the loan of the stock by X to B, the latter is required to deposit with X the full market price of the stock, and thereafter, so long as the loan con-

tinues, the sum in the hands of X is kept, by payments back and forth, between the two brokers, at the market price of the stock as it fluctuates. These payments back and forth are called "mark-ups" and "mark-downs" (Finding of Fact X; R. 7.)

X, the broker lending the stock, has the use of the money deposited with him, and he pays to B, the broker borrowing the stock, interest at such rate as is agreed upon between them from day to day. The usual rate is about the same as the prevailing rate for "call loans" of money (Finding of Fact XI; R. 7).

There may be circumstances in which stock cannot readily be borrowed, and in such case the payment of interest is waived and the stock is then said to be loaned "flat" (Finding of Fact XI; R. 7). So, too, there may even be instances where the borrowing broker B may be required to pay a premium to X, the lending broker, in order to secure the loan of the stock, which may temporarily be in great demand (Finding of Fact XI; R. 7).

Such a loan of stock may be terminated by either the borrowing broker B or the lending broker X upon demand. The lending broker X may "call" the loan at any time, in which event the borrowing broker B must borrow similar stock from another broker "Y" in order to return the stock to X. There may be successive borrowings by B from X, Y, Z and still other brokers, B borrowing stock from each in turn to return it to the preceding lender, before B's customer A chooses to close the transaction (Finding of Fact XVI; R. 8).

The customer A having made a short sale, is not a party to the numerous borrowings and returns of stock which may be necessary in order to keep him short of the stock in question. The only obligation which he assumes is that of putting his broker B into possession of stock at some future time sufficient to "cover" his short sale. This is ordinarily done by directing the broker to purchase such stock on the market for A's account and "covering" the short sale there-

with. It may, however, be done by A's delivering to B, from whatever other source it may be available, the requisite number of shares of the specified stock. It is the duty of the broker B to keep the short sale open, and, as we have indicated, the broker does this by making delivery in the "regular way" and borrowing the stock from one broker or another as often as may be necessary to continue the short sale in statu quo. Of these numerous borrowings and returns of stock, the short seller A receives no notice (Finding of Fact XIII; R. 7). The lending and borrowing brokers deal with each other in their own names. The names of their customers do not appear in the transactions (Finding of Fact XVII; R. 8).

When the lending broker X calls the loan and the borrowing broker B borrows from Y a "loan ticket" is delivered by Y to B, and when B returns the stock to X, the first lending broker, a "borrowed stock returned ticket" is delivered. The stamps claimed here were in part affixed to those "tickets." Similarly with reference to successive borrowings, if any, from broker Z and still others.

When finally the short seller A desires to terminate the short transaction, he usually orders B, his broker, to buy an equivalent amount of similar stock to "cover" the short sale. B thereupon proceeds to purchase the stock from another broker, whom we will call "L." This purchase is made in the regular way and a "sales ticket" is delivered by L to B on the following day when the stock is delivered to him. (No claim is made by the claimants with respect to the stamps so affixed to "sales tickets.") B, in turn, delivers the stock to X, the lending broker (or if X had previously called the loan, to Y or Z or such other broker as B may have thereafter borrowed from) and upon such redelivery a "borrowed stock returned ticket" is handed to the lending broker. The lending broker, X, Y or Z, thereupon returns to B the amount of the deposit of cash which he had been holding, subject to the necessary adjustments of interest, etc. (Finding of Fact XV; R. 8).

The short sale is then completely closed.

A short sale, as we have indicated, ordinarily calls for a subsequent purchase, just as a purchase in a stockbrokerage account is ordinarily followed by a sale. Such sale, followed by a purchase, or purchase followed by a sale, is commonly called a "transaction."

In the case of a "long" transaction, i. e., a purchase of stock followed by a subsequent sale, two taxes are imposed, one on the purchase* and another on the sale. In the case of a "short" transaction, which is merely the reverse of a long transaction, at least four separate taxes, and often six, eight, ten or more, were imposed by the Internal Revenue officials purporting to act under the Revenue Acts of 1917 and 1918. Taxes were paid not only on the sale and subsequent purchase* (to which no objection is made by the claimants), but claimants were also forced to place Federal stock transfer stamps upon each "loan ticket," and each "borrowed stock returned ticket," however many such borrowings and returns there may have been in connection with a single short sale. This claim is for the recovery of these excessive additional taxes which claimants were forced to pay.

It should be borne in mind that, fundamentally, there is no difference between a short and long transaction. As a matter of fact B's customer, A, probably knows nothing of what the broker does in order to enable him to sell short. So far as A is concerned, it is only a matter of expediency and judgment as to whether he shall first buy and later sell, or first sell and later buy. He is not interested in and probably knows nothing of the mechanism of a short sale. The *modus operandi* is a matter which concerns only the broker. The customer's only function is to give his order to sell, and later, when he desires to "cover", to give his order to purchase. All of the more or less complicated steps which are taken in the interim between the order to sell and the order

* Literally the tax is imposed on the sale, which is the obverse side of the transaction.

to buy are made necessary only by reason of the rule of the Stock Exchange requiring delivery to be made on the business day following the sale, unless otherwise stipulated.

The question which at once presents itself is—what motives actuate a broker in lending stock to another broker? That it is purely a business transaction and not a mere act of courtesy is manifest from the fact that such lending and borrowing are part of the routine business of practically all stockbrokers, and obviously there must be an advantage to the lender, as well as to the borrower of stock. That there is such reciprocal advantage is clear from the facts which we will indicate.

It is a matter of common knowledge that the stockbrokerage business is one which is financed in very large part by money raised upon the pledge of securities. Few brokers, if any, have resources sufficient to carry the margin accounts of customers on their books without aid from outside sources. Brokers usually resort to bank loans secured by the deposit of stocks and bonds, which in large part are held by them as collateral for their customers' margin accounts. The law recognizes the right of stockbrokers to repledge securities, held by them as margin, to the extent at least of the amount of the customers' indebtedness against such securities.

When a broker resorts to a bank for the loan of money, the bank usually requires that the value of the securities which are deposited with it as collateral should be about 25% in excess of the amount of the loan made by it.

From our survey of the procedure in effecting a short sale, it is apparent that a broker may with greater convenience raise money by lending securities to other brokers. The essence of the transaction, so far as the broker lending the stock is concerned, is identical with a loan obtained from a bank. In other words, just as in a bank loan the broker deposits securities with the bank and receives in return therefor a sum of money, so when a broker lends securities to another broker he likewise receives in return a sum of money.

In the case of a bank loan, the amount of money which he receives is generally 20% less than the value of the securities deposited. In the case of the lending of stock, the amount of money which he receives is equivalent to the market value of the securities loaned.

Just as in the case of a bank loan, (generally a "call loan") (a) the broker may at any time upon payment of the amount of the loan to the bank receive back his securities, and (b) vice versa, the bank may upon demand and tender of the securities receive back the amount of its loan, so in the case of the lending of stock by one broker to another, (a) the broker lending the stock may upon demand and upon tender of the amount of money deposited with him, demand and receive back his securities, and (b) vice versa, the broker borrowing the stock may upon demand and upon tender of the securities receive back the money deposited with the other broker.

The outstanding advantage of a "broker" loan over a bank loan is that, whereas in a bank loan the broker receives only four-fifths of the value of his securities, he receives the full value thereof when the money is raised by the loan of stocks to another broker. In other words, there is a distinct advantage to the broker when he lends stocks to another broker, for he not only has the use of the money at a rate of interest which may be slightly less than the bank rate, but he has the use of a greater amount of money proportionate to the value of the securities deposited than he would have in the case of a bank loan.

In all respects so far as the purpose and intent of the broker lending the stock are concerned, he is actually obtaining the use of money against securities deposited with the broker borrowing the stock, just as he similarly obtains the use of money when he procures a loan from a bank against the deposit of securities as collateral. When a loan of stock is made by one broker to another for the purpose of completing a short sale there are, therefore, two considerations which

result in the consummation of the transaction, i. e., first, the desire on the part of the broker borrowing the stock to procure stock for delivery to complete the short sale, and secondly, the desire on the part of the broker lending the stock to procure the use of money against the loan to or deposit with the former of the stock in question.

For purposes of brevity and convenience, we shall call the broker borrowing the stock "the borrowing broker," and the broker lending the stock "the lending broker." It should be borne in mind, however, that the broker borrowing the stock is at the same time lending an equivalent amount of money, and, vice versa, the broker lending the stock is at the same time borrowing an equivalent amount of money. The lender of stock is a borrower of money. The borrower of stock is a lender of money.

It is important to note that the various incidents to the ownership of stock exist in the case of the loan of stock, in the same manner as where there is a loan of money by a bank with the deposit of stock as collateral. If any dividends are declared on the stock, whether cash dividends or stock dividends, the "lending broker" receives the benefit thereof, and all other rights and privileges in connection with the stock remain the property of the "lending broker" as against the "borrowing broker" (Finding of Fact XII; R. 7). On the other hand if any assessments are levied on the stock during the existence of the loan, the "lending broker" must pay them, and all other burdens in connection with the stock remain with the "lending broker" (Finding of Fact XII; R. 7).

When the provisions of the War Revenue Act of 1917, governing the imposition of stamp taxes, became effective on December 1, 1917, the question arose as to the applicability thereof to the various interchanges of securities necessary to effect a single short sale. It is apparent from our discussion of the mechanism of an ordinary short sale that in the very simplest case there are four different physical steps i. e., (1), the sale by broker B, the selling broker to C, the purchasing broker; (2), the lending by broker X

to broker B of an equivalent amount of stock, borrowed by B in order to make delivery to C; (3), the subsequent purchase* by B of an equivalent amount of stock in order to "cover" the short sale and thus close the transaction, and (4), the return of the borrowed stock to broker X.

As a matter of fact, as we have already indicated, the second and fourth steps may be repeated several times before the short sale is finally closed, for the lending broker may at any time demand the return of his stock and the borrowing broker must thereupon borrow from another broker. The first and third steps which we have outlined, i. e., the short sale itself and the subsequent purchase, are the same as any other purchases and sales, and required the payment of the tax imposed by the War Revenue Acts of 1917 and 1918. No claim is made with reference to the taxes paid in connection with the first and third steps. This claim is limited to the taxes paid in connection with the second and fourth steps.

There is nothing in paragraph 4 of Schedule A of Article VIII of the War Revenue Act of 1917, nor in the similar provision of the 1918 Law, which imposed a tax upon the lending of stocks or the subsequent return thereof or the various intermediate borrowings and returns of stock which may be necessary during the existence of a short sale. And if our statements are correct, that the lending of stocks by one broker to another is an act which to all intents and purposes is equivalent to the borrowing of money upon the security of the stocks so loaned, such transactions clearly come within the proviso contained in those laws

"that it is not intended by this title to impose a tax upon an agreement evidencing a deposit of certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon the delivery or transfer for such purpose of certificates so deposited"

* Literally the tax is imposed on the sale, which is the obverse side of the transaction.

(Excerpt from Paragraph 4 of Schedule A of Article XI of the War Revenue Law of 1918. A similar provision was contained in the War Revenue Law of 1917).

The question of the interpretation of the provisions of the 1917 law with respect to the imposition of the stamp tax upon the borrowing and return of stocks was apparently a troublesome one to the Commissioner of Internal Revenue. Originally, after various conferences in New York and Washington, in which representatives of the Department of Justice, the Internal Revenue Bureau, Special Counsel for the Government, and representatives of the New York Stock Exchange took part, it was determined that such transfers were not taxable. It was only after the question had been submitted to the Attorney General and an opinion rendered by the Attorney General to the effect that the lending of stocks and the return of borrowed stocks were taxable under the 1917 Law, that the Commissioner of Internal Revenue issued Treasury Decision 2685, which we have already quoted.

As a result of the foregoing ruling, the claimants were compelled, during the month of May, 1918, to purchase and cancel Federal Stock Transfer Stamps to cover all transactions from December 1, 1917, to the date of such purchase and cancellation, which had consisted either of the lending of stocks or the return of borrowed stocks and from that time on until May 31, 1920 (the period covered by this claim) the claimants were required to affix and cancel Federal Stock Transfer Stamps in connection with every such transaction.

The stamps in question were affixed to the "loan tickets," which, as we have indicated, were delivered by claimants to the borrowing brokers when claimants loaned stock (Finding of Fact IX, R. 7) and to the "borrowed stock returned tickets," which similarly were delivered by claimants to the lending brokers when claimants returned stock they had previously borrowed.

This claim squarely raises the question whether the tax imposed by the Acts of Congress above referred to was intended to apply to the borrowing and return of stocks under the circumstances indicated.

That claimants filed their claim with the Commissioner of Internal Revenue, and that such claim was not acted upon, and that more than six months elapsed since the filing of such claim, is stipulated (Finding of Fact XXVII; R. 11). While the claim filed with the Commissioner of Internal Revenue was not accompanied by the cancelled stamps for the refund of the value of which the claim was made, the reason why such stamps could not be submitted was set forth, to wit, that the stamps were affixed to "loan tickets" and "borrowed stock returned tickets," which documents were delivered to the other brokers in the transactions.

The claimants contend that it is apparent from the language of those laws and from the facts hereinabove indicated, (1) that the transactions referred to do not fall within the enacting clause of either the 1917 or 1918 Revenue Acts, in that they do not constitute sales, or similar transfers of legal title, and (2) that such transactions are equivalent to the deposit of stock certificates as collateral security for money loaned thereon and are, therefore, expressly exempt from tax by reason of the first proviso of Schedule A of Paragraph 4 of each of said Acts. The taxes which claimants were compelled to pay were, therefore, erroneously and illegally collected.

THE HOLDING OF THE COURT OF CLAIMS.

The learned Court below held that, under the foregoing facts, the Treasury Department properly required the claimants to affix and cancel internal revenue stamps in the case of each loan of stock and each return of borrowed stock.

Briefly summarized the grounds for the learned Court's decision were the following:

1. That the lending of stock constitutes a transfer of legal title.

2. That the practice of short selling is peculiarly speculative in its nature, and that Congress considered this practice to be a proper subject of special taxation to a greater extent than "long" transactions.

3. That the transactions in question do not constitute "a deposit of stock certificates as collateral security for money loaned thereon" within the meaning of the first proviso of Section 4 of Schedule A of the 1917 and 1918 Acts.

OUR CONTENTIONS.

We respectfully contend that :

- I. The history of similar legislation indicates clearly that it was not the intent of Congress to tax the borrowing and return of stock among brokers.
 - A. Earlier taxing acts, similar in language and purpose, were held not to apply to such transactions.
 - B. The reenactment in the 1918 Act of the stamp tax provisions of the 1917 Act, does not indicate a ratification by Congress of the Treasury Department's ruling.
 - C. The Revenue Act of 1921 contains an express declaration disapproving the Treasury Department's interpretation of the 1917 and 1918 Acts.
- II. There is no ground for inferring that Congress intended to discriminate against short sales or to impose a greater tax on "short" than on "long" transactions, nor is there any ground for assuming that Congress knew of the practice of brokers to borrow and return stocks in connection with short sales and intended to tax such borrowing and return.

III. The transactions involved in this claim are not taxable under the enacting clauses of the 1917 and 1918 Acts.

- A. The word "deliveries" as used in the 1917 and 1918 Acts cannot be held to apply to every transfer of physical possession. It must be construed in the light of its context, and as so construed must be limited to sales and other similar transfers of legal title.
- B. The lending of stock as practised by brokers, does not constitute a transfer of legal title. The relation between the lending broker and borrowing broker is that of pledgor and pledgee. The transaction being a pledge, there is no transfer of title.
- C. The opinion of the Attorney General, upon which Treasury Decision 2685 was based, was rendered without a complete understanding of the facts and was based upon an erroneous assumption of the facts and a misapprehension of the law applicable to the transactions in question.

IV. The lending of stock is equivalent to the deposit of stock as collateral security for money loaned thereon, and is, therefore, exempt from tax under the first proviso of Paragraph 4 of Schedule A.

POINT I.

THE HISTORY OF SIMILAR LEGISLATION INDICATES CLEARLY THAT IT WAS NOT THE INTENT OF CONGRESS TO TAX THE BORROWING AND RETURN OF STOCK AMONG BROKERS.

A.

Earlier taxing acts similar in language and purpose were held not to apply to such transactions.

The 1917 Act was not the first law to tax transfers of shares of stock. However, Treasury Decision 2685 was the first

official declaration that the borrowing and return of stock in connection with short sales were subject to the transfer tax.

The practice of short selling is as old as stock speculation itself, and the fact that a similar tax imposed by earlier acts had never been held to be applicable to the borrowing and return of stock incident thereto should be of real weight in determining whether Congress intended in the 1917 and 1918 Acts to tax such transactions.

The first imposition in the United States of a tax upon stock transfers is found in the Revenue Act of 1864, as amended in 1866 (14 Stat. L. 142), which imposed a stamp tax upon every

"bill or memorandum of the sale or contract for the sale of stocks, bonds, gold or silver, bullion, coin, promissory notes or other securities."

So far as we can discover no attempt was ever made under that law to tax the borrowing and return of stocks incident to short sales.

The 1898 Revenue Law (30 Stat. L. 448, 458) was the model of the more recent laws. The pertinent part of Schedule A, which fixed the nature and amount of the tax, read as follows:

"* * * and on all sales, or agreements to sell, or memoranda of sales or deliveries or transfers of shares or certificates of stock in any association, company or corporation, whether made upon or shown by the books of the association, company or corporation, or by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale whether entitling the holder in any manner to the benefit of such stock, or to secure the future payment of money or for the future transfer of any stock, on each hundred dollars of face value or fraction thereof, two cents." // +

No effort was made, so far as we can find, to tax the borrowing and the return of borrowed stocks under this law.

Never applied to loans

The Act of 1914 (38 Stat. L. 759), which was the next revenue law which imposed a tax upon transfers of stock, imposed a tax in Schedule A, as follows:

"on all sales, or agreements to sell or memoranda of sales or deliveries or transfers of shares or certificates of stock in any association, company or corporation whether made upon or shown by the books of the association, company, or corporation, or by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock, or to secure the future payment of money or for the future transfer of any stock, on each \$100 of face value or fraction thereof, 2 cents; Provided, That it is not intended by this Act to impose a tax upon an agreement evidencing a deposit of stock certificates as collateral security for money loaned thereon, which stock certificates are not actually sold, nor upon such stock certificates so deposited."

This law, from which the 1917 act was copied almost verbatim, was never held to apply to the borrowing and return of stock incident to short sales.

The foregoing statutes, we believe, are all that were ever enacted by Congress imposing a tax upon transfers of stock prior to the enactment of the 1917 War Revenue Act with which we are concerned in this claim.

Could it have been a mere inadvertence that the Treasury Department did not enforce payment of the tax with respect to the borrowing and return of stocks during the existence of the earlier statutes, particularly the 1898 and 1914 acts? We think not. The practice of selling short is so common that it would tax one's credence if it were suggested that these transactions were merely overlooked by the Treasury Department.

Had Congress intended that these transactions should be taxed would it have been likely that a misapprehension of its

intent on the part of the Treasury Department would not have been corrected by an explicit enactment in the subsequent laws? Yet we find that in spite of the fact that these transactions were not taxed under the 1914 Act and the earlier similar Acts, Congress in the 1917 Act, in almost identical words, re-enacted the provisions of the 1914 law relating to stock transfers.

Upon what theory then can it be said that Congress intended to change the application of the law and broaden its scope? We can conceive of none for which support can be found in anything contained in the 1917 Revenue Law. On the contrary, the use of similar language by Congress indicates that there was no intention to depart from the previously established limitations of the tax.

The Treasury Department, under the earlier revenue acts, by its omission to enforce payment of such tax on the borrowing and return of stock incidental to short sales, had tacitly ruled that such transfers were not taxable under such acts. It had gone further and had *expressly* ruled that the borrowing and return of stocks, under similar circumstances (even though borrowed for another purpose) were not taxable; i. e., the borrowing of stocks by one broker from another pending the arrival of the particular certificates sold on behalf of the borrowing broker's customer. Treasury Decision 2182, in which the Treasury Department construed the almost identical language of the 1914 Act, read as follows:

"Treasury Department
Office of Commissioner of Internal Revenue,
Washington, D. C., March 26, 1915.

A. M. Kidder & Co.,
5 Nassau Street, New York.

Gentlemen:

This office is in receipt of your communication of the 19th inst., in which you request to be advised upon the following:

'A certain stock is sold regular way; delivery cannot be consummated because of nonarrival, so the security is borrowed. Stamps in accordance with the Emergency Revenue Law of 1914 are affixed to bill of sale and delivery made. In due course the seller is in position to return the borrowed stock. He presents the stock to transfer office to have transferred for delivery to the lender. This transfer does not represent a change of ownership. Will it be necessary to affix transfer tax stamps?'

Replying, you are informed that for a bona-fide transaction as above, this office is of the opinion that documentary stamps are not required on account of the lender transferring certificates of stock to the borrower, nor the borrower returning similar certificates of stock in the same corporation to the lender. Upon a transfer, however, under such circumstances, a certificate should be attached to the effect that it is an exchange on account of an accommodation loan, and that, in accordance with the ruling of this office, documentary stamps are not required on account of such accommodation loan and return.

Respectfully,

G. E. FLETCHER,
Acting Commissioner."

A short sale is nothing more than a sale for deferred delivery. What difference can it possibly make whether the reason for the deferred delivery is the temporary inability on the part of the seller to deliver certificates which he owns, or his purpose to subsequently acquire similar certificates to complete the sale? So far as the broker is concerned, every order to sell, where the broker is not put into possession of the stock required for delivery in the regular way, must be treated as a short sale and must be handled accordingly.

In every such case the broker borrows the stock and makes delivery in the regular way, whatever may be the reason why the stock is not then made available by the seller.

There is no legal distinction between the borrowing and return of stock under the circumstances disclosed in Treasury Decision 2182, and the borrowing and return of stock under the circumstances disclosed in Treasury Decision 2685. In both cases the certificates borrowed were to be used to make delivery to a purchaser thereof, and there was no intention that the same certificates be returned to the lending broker. So far as the question of title is concerned (and this is the argument upon which the Government places the strongest reliance) no distinction exists between the case of the borrowing for one purpose and that in the other. If the borrowing of stock because of the "non-arrival" of the stock sold "does not represent a change of ownership," how can it be said that the borrowing of stock for other reasons represents a change of ownership?

The Treasury Department, in Treasury Decision 2182, apparently accepted the proposition, which they now so strongly contest, that the lending of stock is a transfer which "does not represent a change of ownership." That attitude was not limited to the lending of stock for accommodation pending the arrival of certificates sold by the borrowing broker. The Treasury Department, so far as we can learn, did not under the 1914 Act adopt a contrary ruling with respect to the lending of stock incident to short sales, and it is our understanding that the ruling contained in Treasury Decision 2182 was considered applicable to such transfers.

As a matter of fact, even after the enactment of the 1917 Revenue Law, no effort was made to collect the tax upon the lending and return of stocks incident to short sales until some months after the stamp tax provisions became effective. During the interval between December, 1917, and May, 1918, the blanks furnished by the Internal Revenue Bureau, upon which claimants were required to make monthly return of stamps used by them, did not provide any space for a report

of stamps used on loans of stock and returns of borrowed stock.

The ruling of the Treasury Department contained in Treasury Decision 2685 was not the result of a sudden discovery of transfers which had hitherto been inadvertently overlooked.

Treasury Decision 2685 was a totally unexpected and complete reversal of the Treasury Department's former position, not only with respect to previous similar Acts, but also with respect to the very Act to which it related.

These facts, we believe, should be enough to indicate that unless a contrary intention were clearly expressed in the 1917 Revenue Law, the construction previously adopted in connection with earlier legislation substantially similar in language and purpose was intended to apply to the 1917 Act.

It is well established that where an earlier Act has, over a long period of time, been construed in a certain way, a re-enactment by Congress of a law containing substantially the same provisions is to be construed in conformity with the construction of the earlier statute.

In *Copper Queen Mining Co. v. Arizona Board*, 206 U. S. 474, Mr. Justice Holmes said (p. 479) :

"And again, *when for a considerable time a statute notoriously has received a construction in practice from those whose duty it is to carry it out, and afterwards is re-enacted in the same words, it may be presumed that the construction is satisfactory to the legislature, unless plainly erroneous, since otherwise naturally the words would have been changed.*" (Italics ours.)

Similarly in *United States v. Cerecedo Hermanos y Compania*, 209 U. S. 337, this Court said (p. 339) :

"And we have decided that the re-enactment by Congress, without change, of a statute, which had previously received *long continued* executive construction, is

an adoption by Congress of such construction." (*Italics ours.*)

In *McDonald v. Hovey*, 110 U. S. 619, the Court said (p. 628) :

"The phraseology of the Act of 1872 * * * is so nearly identical with that of * * * the Act of 1789, * * * that we must presume they were intended to have the same construction, and the Act of 1789 contains no language which requires that it should have a different construction from that which *had long been established* in reference to all the statutes of limitation then known, whether in the mother country or in this." (*Italics ours.*)

In *National Lead Co. v. United States*, 252 U. S. 140, the Court in construing the statute pointed out that a method adopted by the Treasury Department in computing the amount of drawback to be paid upon the re-exportation of products previously imported had been followed forty years without objection. The Court held that a subsequent re-enactment of the Act authorizing the repayment of duties in such case in substantially similar language constituted an approval of the executive construction of the prior Act. The Court said (p. 146) :

"The re-enacting of the drawback provision four times, without substantial change, while this method of determining what should be paid under it was being *constantly* employed, amounts to an implied legislative recognition and approval of the executive construction of the statute." (*Italics ours.*)

B.

The reenactment in the 1918 Act of the Stamp Tax provisions of the 1917 Act, does not indicate a ratification by Congress of the Treasury Department's ruling.

Counsel for the Government, in the Court of Claims, argued that the reenactment by Congress in the 1918 Act of the stamp tax provisions of the 1917 Act amounted to an adoption by Congress of the construction by the Treasury Department of the similar provisions of the 1917 Act. Counsel argued and the learned Court of Claims held, that this reenactment effectively disposed of the question of the proper construction of both the 1917 and 1918 Acts.

The argument of counsel, and the opinion of the learned Court below, are unsound because

(a) An application of the same canon of construction to the 1917 Act, of which the 1918 Act is a reenactment, necessarily leads to a contrary interpretation of the language of the enacting clause.

(b) The canon of construction is properly applicable to the 1917 Act but not to the 1918 Act, because in the latter case there had not been a long continued and harmonious executive construction.

(c) No inference can be drawn from the reenactment in the 1918 Act of the taxing provisions of the 1917 Act because the question of the construction thereof was not considered or discussed.

(a) *An application of the same canon of construction to the 1917 Act, of which the 1918 Act is a reenactment, necessarily leads to a contrary interpretation of the language of the enacting clause.*

If the argument of counsel has any force at all, it leads to a most peculiar and anomalous situation. It will be recalled

that we argued that the canon of construction upon which the Government relies makes it necessary to hold that in enacting the 1917 Revenue Act, Congress evidenced an intent to adopt the construction by the Treasury Department of the similar language contained in the 1898 and 1914 Acts, *under which construction the lending and return of stocks were not taxable*. The Government, however, now attempts to apply the same canon of construction to the 1918 Act and contends that the reenactment, in that Act, of the provisions of the 1917 Act must likewise be deemed to be a ratification and approval of Treasury Decision 2685, *under which the lending and return of stocks are held to be taxable*.

The language in each of the acts is similar; in fact, so far as this case is concerned, the acts may be considered to be substantially identical in terms. If the application of the same canon of construction leads to diametrically opposite interpretations of identical language, surely there is something radically wrong either with the canon of construction or with the argument that it is applicable to one or the other of the statutes. The canon of construction, as the Court below remarked, is an ancient one, and it has always been accepted as a safe guide in determining legislative intent. There must, therefore, be something wrong with its application, either to the 1917 Act, as indicated in the first subdivision of this point, or with the effort of counsel for the Government to reach a contrary conclusion by the use of the same test. We respectfully urge that it is the latter.

- (b) *The canon of construction is properly applicable to the 1917 Act but not to the 1918 Act, because in the latter case there had not been a long continued and harmonious executive construction.*

The most obvious error in the Government's argument and the opinion of the Court is that both failed to give consideration to the limitations upon the use of this canon of construction. One of those limitations, and the most vital one, is that

an executive construction of language used in a preceding statute is not deemed to be ratified by a reenactment of the same language in a subsequent act, *unless such executive construction has been long continued*. It will be recalled that in our discussion of this rule (pages 24 and 25 *supra*), we emphasized the fact that the authorities in support thereof were expressly limited to cases in which the construction contended for had prevailed *over a long period of time*.

In addition to the cases which we there cited, there are numerous others to the same effect, among them

United States v. Philbrick, 120 U. S. 52;
Komada & Co. v. United States, 215 U. S. 392;
United States v. Falk & Bro., 204 U. S. 143;
New Haven Railroad Co. v. Interstate Commerce Commission, 200 U. S. 361.

In the *Philbrick* case, *supra*, this Court, in January, 1887, held (p. 59):

"* * * and since that act, as well as the one of 1866, is an implied recognition of the practice established in the Navy Department *prior to 1835, we are not disposed, at this late day*, to question the validity of the order of May 23, 1866. That order was in accordance with the construction which the Executive Department, *for many years prior to 1835*, placed upon the various statutes relating to the naval establishment and defining the powers of the Secretary of the Navy." (Italics ours.)

In the *Komada*, case, *supra*, decided in January, 1910, this Court held (p. 397):

"Thus it appears that prior to 1894 (as far back as 1893) sake was classified by similitude to distilled liquor, and then on a protest by an importer it was classified by similitude to still wine, and that ruling has been followed from that time to the present. * * *"

In the *Falk* case, *supra*, this Court held (p. 150) :

“And the Attorney General’s opinion cannot be overlooked. The proviso which he construed * * * was re-enacted in Section 33 of the Act of 1897. It would be extreme to hold that Congress by doing so intended to set up the technical rule relating to provisos against the construction of the attorney general and to change that construction by repeating the very words construed. And there could have been no oversight. *The practice of the executive officers for years gave emphasis and materiality to the construction.*” (Italics ours.)

In the *New Haven Railroad Co.* case, *supra*, this Court, after discussing the rule, refused to apply it because the limitations applicable thereto prevented it from having any effect upon the question before it. The Court said (p. 401) :

“We make this concession, because we think we are constrained to do so, in consequence of the familiar rule that a construction made by the body charged with the enforcement of the statute, which *construction has long obtained* in practical execution, * * * must be treated as read into the statute. * * * The concessions thus made, however, are *wholly irrelevant to the case before us.*” (Italics ours.)

It will be noticed in all of the foregoing opinions that this Court emphasized the fact that the approval by Congress of the construction of the Executive Department could be implied only where that construction had prevailed over a long period of time. Obviously, that rule can have no application, in favor of the Government, in the present case.

Treasury Decision 2685 was promulgated on March 30, 1918. The time which elapsed fell so far short of indicating a “long continued” executive construction that the canon of construction above referred to cannot possibly be held to be applicable.

Another limitation, and likewise a vital one, upon the use of the canon of construction, is that the executive construction must not only be long continued, but also *uniform and harmonious*.

For example: In *United States v. Healey*, 116 U. S. 136, a question was raised as to the construction of the Act of March 3, 1887, which provided for the sale of desert land in certain states. It became necessary to determine whether this Act embraced alternate sections along the lines of railroads reserved to the United States. Mr. Justice Harlan indicated that the administrative interpretation of this Act by the Interior Department had not been uniform and harmonious and that therefore the Court could not look to the administrative interpretation of the Act of 1877 as an aid in determining the proper construction of a subsequent reenactment thereof.

Mr. Justice Harlan said (p. 145):

"From this review of the administration by the Interior Department of the act of 1877, it appears that, for ten years after the passage of that act, 'desert lands,' even if they were alternate reserved sections along the lines of land-grant railroads, could be obtained from the government at the price of \$1.25 per acre; that after June 27, 1887, and until the passage of the act of March 3, 1891, c. 561, the act of 1877 was administered upon the theory that it did not modify or conflict with section 2357 of the Revised Statutes, and therefore did not include alternate sections reserved to the United States along the line of land-grant railroads, the price for which was fixed at \$2.50 per acre; that the act of 1891 was interpreted to mean *all* desert lands, those within as well as those without the granted limits of a railroad, and to authorize their sale at \$1.25 per acre; and that cases *initiated* under the act of 1877 should, in respect to price per acre of lands, be completed according to the terms prescribed by the act of 1891.

"If, prior to the passage of the act of 1891, the Interior Department had uniformly interpreted the act of 1877 as reducing the price of alternate reserved sections of land along the lines of land-grant railroads, being desert lands, from \$2.50 to \$1.25 per acre, we should accept that interpretation as the true one, if, upon examining the statute, we found its meaning to be at all doubtful or obscure. *But as the practice of the Department has not been uniform, we deem it our duty to determine the true interpretation of the act of 1877, without reference to the practice in the Department.*" (Italics ours.)

Similarly in *Merritt v. Cameron*, 137 U. S. 542, Mr. Justice Lamar said (p. 551) :

"In arriving at this conclusion we are not unmindful of the fact that the defendants in error made their protest in accordance with the regulations of the Treasury Department in force at that time. A regulation of a department, however, cannot repeal a statute; neither is a construction of a statute by a department charged with its execution to be held conclusive and binding upon the courts of the country, *unless such construction has been continuously in force for a long time.* The cases cited go to that extent and no further. *In regard to the law under consideration the construction of it by the Treasury Department has not been uniform.* The construction contended for by defendants in error first arose in 1876 and lasted only until 1885, since which time the construction has been the same as in this decision. *There is no such long and uninterrupted acquiescence in a regulation of a department, or departmental construction of a statute, as will bring the case within the rule announced at an early day in this court, and followed in very many cases, to wit, that in case of a doubtful and ambiguous law the contemporaneous construction of those who have been called upon to carry it into effect is entitled to great*

respect, and should not be disregarded without the most cogent and persuasive reasons."

The construction placed upon the Act of 1917 by the Treasury Department was not only not long continued, but during the short period of nine months between the effective date of the stamp tax provisions of the 1917 Act, and September 11th, 1918, when counsel for the Government claim the question was presented to the Senate Finance Committee, the Treasury Department had taken two diametrically opposite positions with respect to the taxability of the lending and return of stocks. From December 1st, 1917 to March 30th, 1918, a period of four months, the Treasury Department had held that such transactions were not taxable and this we have seen was a continuation of the ruling under the former and similar statute. From March 30th, 1918 to September 11th, 1918, a period of slightly over five months, the Treasury Department had reversed its former position and construed the 1917 Act as requiring the payment of a tax upon such transactions. Surely the Government cannot sincerely argue, under these circumstances, that there had been such *long continued, uniform and harmonious construction* by the Treasury Department of the provisions of the 1917 Act that Congress in reenacting those provisions in the 1918 Act is to be deemed to have ratified that construction.

An excellent example of the limitations applicable to the rule contended for by the Government is found in the recent case of *Casey v. Sterling Cider Co.*, 294 Fed. 426 (C. C. A., 1st Circuit). In that case the Court said (p. 429):

"The plaintiff in error has taken a further position in his brief and argument, apparently not covered by his assignments of error, to the effect that sec. 628 (a) is a reenactment, without change, or substantial change, of the provisions of sec. 313 (b) of the Revenue Act of 1917; that on or about May 31, 1918, the Treasury Department promulgated article 31, regulation 44, con-

struing section 313 (b) as making sweet cider taxable; that Congress was familiar with the provisions of regulation 44 when it enacted section 628 (a) in February, 1919, and did so with the intention that sweet cider should be taxable thereunder. If it be assumed that the question is properly before us, this contention cannot be sustained, for we do not regard section 628 (a) as a reenactment of section 313 (b) without substantial change. Then again, we cannot, on the facts of this case, assume that Congress knew of and considered regulation 44 as stating the true construction of section 313 (b). *The regulation had not been in existence for any considerable length of time when section 628 (a) was enacted, and there is nothing to show that it had been consistently enforced and acquiesced in even during that length of time, so that it would be likely to have been known to Congress. The time that elapsed between the promulgation of the regulation and the enactment of the Revenue Act of 1918, of which section 628 (a) was a very small part, was only about nine months, and the act was undoubtedly drafted and introduced long prior to its final adoption.*" (Italics ours.)

- (c) *No inference can be drawn from the reenactment in the 1918 Act of the taxing provisions of the 1917 Act because the question of the construction thereof was not considered or discussed.*

So far as appears from the records of Congress or any of its committees, the matter of the tax upon the lending of stock and the return of borrowed stock received no consideration at the time the Revenue Act of 1918 was being formulated, except only that at one of the numerous hearings before the Senate Committee on Finance one Mr. Maloney, who claimed to be a member of the Consolidated Stock Exchange of New York (not the New York Stock Exchange), appeared before the Committee on September 11, 1918, and called attention to

the opinion of the Attorney General, upon which Treasury Decision 2685 was based, and to the fact that such opinion caused considerable dissatisfaction among stockbrokers, by reason of the multiple taxes imposed in connection with short sales. (Hearings before Committee on Finance, United States Senate, Sixty-fifth Congress, Second Session, on H. R. 12863, page 196.) This is wholly immaterial, as the construction of the act of Congress could not be determined by any circumstance of that sort.

An examination of the Committee Report (Senate Report 617) fails to disclose any mention of the question of the tax upon the lending and return of stocks. The report stated (p. 57) :

"The bill reenacts the stamp tax provision of the Revenue Act of 1917 without changing the rates except in one instance" (the change referred to is in connection with the tax on playing cards).

More important still is the fact that the matter was not brought to the attention of the House of Representatives or any of its committees at all.

Naturally, the matter not having been brought to the attention of the House Ways and Means Committee, no record of any discussion of the tax on the lending and return of stocks is found in the proceedings of that body. The committee report contains a statement similar to that already referred to in connection with the Senate report (House report No. 767, page 37) :

"The bill reenacts the stamp tax provision of the Revenue Act of 1917 without changing the rates except in one instance."

It was not even referred to in any of the committee reports, nor upon the floor of either house.

It is well settled that communications made to a committee of a legislative body can receive no consideration in connec-

tion with the construction of an act subsequently passed, particularly when the proceedings before the committee are not made known to the legislative body itself in the report of the committee.

The rule is stated in *Black on the Interpretation of Laws*, as follows (p. 312) :

"And while the reports of committees possess a semi-official character, it is not so with the papers which a committee may have had before them, such as reports of administrative officers or commissions, or letters and petitions addressed to the committee, and these have no weight and should not be considered in seeking the proper construction of a statute." (Italics ours.)

In *United States v. Allen*, 179 Fed. 13, (C. C. A., 8th Circuit; reversed on other ground in 224 U. S. 448), the Court said (p. 18) :

"The trial court held that because a statute conferring the jurisdiction here in question by more direct language was not enacted, *though brought to the attention of the committee* having the present act in charge, that this amounted to an expression of the legislative intent that the right itself either did not exist or was so doubtful that the only proper procedure was to make provision for a judicial determination of its existence. Courts can find the intent of the legislature only in the acts which are in fact passed, and not in those which are never voted upon in Congress, but which are simply proposed in committee. It is not contended that the bill referred to was ever brought to a vote in Congress and rejected. It was simply one of the measures which was under consideration at the time the act of May 27, 1908, was passed. To hold that such facts can be looked to for the purpose of narrowing the effect of a statute actually passed, would be to invent a new and dangerous canon of statutory interpretation." (Italics ours.)

The case of *Thomas v. Vandegrift & Co.*, 162 Fed. 645 (C. C. A., 3rd Circuit), involved the construction of a provision of the Tariff Act of July 24, 1897. The Court said (p. 649) :

"We cannot agree with the counsel for the Government as to the weight to be attached to the communication addressed to the Committee on Ways and Means of the House of Representatives by the Continental Iron Works, dated January 4, 1897, upon the suggestion made in which communication they ask us to infer that the second subparagraph of paragraph 152 of the act of 1897 was inserted. It is true that the communication was from a manufacturer interested in the protection to be derived from a higher duty upon the articles he was manufacturing. But we are only authorized to look at the language employed by Congress, who seem either to have disregarded the suggestion or misunderstood what was required by the manufacturer to accomplish his object."

It is evident that there is nothing whatever to show that Congress, or any committee of Congress, actually passed on the question now presented, and the effort of the Government is simply to have this Court make a purely technical assumption that Congress intended to adopt a recent, new and, as we shall show, an erroneous construction of the statute, overriding an earlier and long continued administrative construction, by the reenactment of the statute, when, in truth, Congress did not deal with the matter at all. At most, Congress left the question where it found it, a matter of conflicting interpretation.

And, when later Congress did deal with the question, it interpreted the situation in accordance with the appellants' claim.

C.

The Revenue Act of 1921 contains an express declaration disapproving the Treasury Department's interpretation of the 1917 and 1918 Acts.

By the Revenue Law of 1921, the tax was imposed in the following terms:

"On all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock or of profits or of interest in property or accumulations in any corporation, or to rights to subscribe for or to receive such shares or certificates, whether made upon or shown by the books of the corporation, or by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum of other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock, interest or rights, or not, on each \$100 of face value or fraction thereof, 2 cents, and where such shares are without par or face value, the tax shall be 2 cents on the transfer or sale or agreement to sell on each share: *Provided, That it is not intended by this title to impose a tax upon an agreement evidencing a deposit of certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon the delivery or transfer for such purpose of certificates so deposited, nor upon mere loans of stock nor upon the return of stock so loaned.*" (Italics ours.)

Exemption section

Agreement to sell

The language of this paragraph is identical with the language of the 1918 Act, with two exceptions:

(1) The elimination of the increased tax upon stock valued at more than \$100 per share (with which we are not interested); and

(2) The addition to the proviso of the following words: "nor upon mere loans of stock nor upon the return of stock so loaned."

The re-enactment of the law in precisely the same language as the former law, with the additional proviso "that it is not intended by this title to impose a tax * * * upon mere loans of stock nor upon the return of stock so loaned" must be held to be an interpretation or construction by Congress of its own language contained in the enacting clause.

We call particular attention to the phrase "it is not intended by this title," etc. The Court will note that the other provisos do not use this phrase. For example, the second proviso reads "provided further, that the tax shall not be imposed," etc. The third proviso reads "provided further, that in case of sale," etc. Is the use of the words "It is not intended" to be deemed to be without meaning? It is one of the canons of statutory construction that the Court will not come to the conclusion that the legislature did not intend a clause to have any meaning, unless there is no alternative for such conclusion.

2 *Sutherland, Statutory Construction* (Second edition) 731.

If Congress had "not intended" by the use of certain words in 1921 to tax the borrowing and return of stock, how could it have been intended by Congress to tax such transfers in 1917 and 1918 by the use of identical words?

Can it be said that a contrary intention was indicated in the 1917 and 1918 Acts, when Congress has expressly declared that the same language, without change in the slightest respect, in a later Act, was not intended to have the meaning which has been assigned to it by the tax officials? Such a contention is illogical and unsound and is contrary to and inconsistent with the express declaration of Congress.

The language used in the 1921 Act indicates in a most forceful and convincing way Congress' complete disapproval

and rejection of the interpretation by the Treasury Department of the language contained in the enacting clause, i. e., the language of the 1917 and 1918 Acts.

Counsel for the Government, in their brief before the Court of Claims, waved aside our argument with the remark that each of these statutes is a "complete enactment in itself, and the only thing that can be argued from changing language in such statutes is a change of legislative intent."

Counsel for the Government probably realized that this statement was a hasty one and not well considered, for it was followed by a more moderate and far more correct statement that "the Legislature *may* in one statute include some occupations or transactions and in the next exclude those previously taxed." This, of course, is self-evident. If we were to argue to the contrary, our argument would be equally as wide of the mark as the Government's claim that a change of language can show *only* a change of legislative intent.

Congress may, of course, change its purpose and make such change of purpose manifest in subsequent legislation. On the other hand Congress may, and frequently does, clarify its purpose by a change of language in subsequent legislation, particularly where the administrative interpretation of the earlier law is erroneous and calls for correction. That it was the purpose of Congress to clarify its earlier language rather than to indicate a change of intent, is made particularly evident in the present case in which the taxing clause is left unchanged, but a proviso is added "that it is *not intended*" to impose a tax upon the transactions involved in this case.

The legislative history of the 1921 Act fortifies and confirms our contention. If it were the intent of Congress to change its tax policy, surely some reference to such change of policy would have been made in the Committee reports.

The report of the House Ways and Means Committee (67th Congress, 1st Session, House Report No. 350) contains considerable discussion of proposed tax changes and of the gain or loss in revenue expected to result therefrom (pp. 3-8). For

example, on page 7 of the report is a discussion of "Miscellaneous Tax Changes" in which the Committee refers to the repeal of the soda fountain tax and the tax on carbonated beverages, to the reduction of the tax on sporting goods, candies, furs, etc., and other minor changes. But there is no mention anywhere in the report of any change in tax policy regarding the taxation of transfers of stock.

In the report of the Senate Finance Committee (67th Congress, 1st Session, Report No. 275 on H. R. 8245), there appears the following:

"Title X—Stamp Taxes * * * In order to avoid double or multiple taxation, it is also provided in paragraph 4 that the stamp tax on the transfer of certificates of stock shall not apply 'upon mere loans of stock nor upon the return of stock so loaned.'"

It is, therefore, evident not only from the peculiar language used in the proviso, to wit, "that it is *not intended*" to impose a tax, etc., but also from the language of the Senate Finance Committee's report, that the purpose of the proviso was not to indicate a change of tax policy and an exemption from taxation of transactions previously intended to be taxed, but rather to cure an error in the executive administration of the tax which had resulted in "double or multiple taxation." It is of precisely such "double or multiple taxation" that we now complain.

This Court has repeatedly held that it is proper to look to the language of a subsequent Act as a guide to the proper interpretation of the provisions of a similar prior Act.

In *Cope v. Cope*, 137 U. S. 682, this Court said (p. 687):

"But whatever doubts there may be regarding the proper construction of this act, we think they are dispelled by a scrutiny of subsequent legislation upon the same subject. * * *

These several acts of Congress, dealing as they do with the same subject matter, should be construed not only as expressing the intention of Congress at the dates the several acts were passed, *but the later acts should also be regarded as legislative interpretations of the prior ones.* *United States v. Freeman*, 3 How. 556, 564; *Stockdale v. Insurance Co.*, 20 Wall. 323." (Italics ours.)

In *Bailey v. Clark*, 21 Wall. 284, the question was whether moneys borrowed from time to time by a banker in the ordinary course of his business constituted "capital" employed by a banker in his business of banking within the Revenue Act of 1866. This Court held (p. 288) :

"After controversies had arisen as to the interpretation to be given to the statute, upon the question at issue in this case, between bankers and the government, Congress passed the Act of 1872, defining the meaning of the terms 'capital employed,' in the 110th section, and enacted that they 'shall not include money borrowed or received from day to day in the usual course of business from any person not a partner of, or interested in, the said bank, association or firm.' *This enactment was evidently intended to remove any doubt previously existing as to the meaning of the statute and declare its true construction and meaning. Had it been intended to apply only to cases subsequently arising it would undoubtedly have so provided in terms.*" (Italics ours.)

Mr. Justice Wayne, in *U. S. v. Freeman*, 3 How. 556, said (p. 564) :

"If a thing contained in a subsequent statute be within the reason of a former statute, it shall be taken to be within the meaning of that statute; Lord Raym. 1028; and if it can be gathered from a subsequent statute in *pari materia*, what meaning the legislature attached to

the words of a former statute, they will amount to a legislative declaration of its meaning, and will govern the construction of the first statute."

In *Tiger v. Western Investment Co.*, 221 U. S. 286, Mr. Justice Day said (p. 309) :

"When several acts of Congress are passed touching upon the same subject matter, subsequent legislation may be considered to assist in the interpretation of prior legislation upon the same subject."

The rule of construction applied in these cases is particularly appropriate to the present case. Its application leads to a uniform and consistent application of the various tax laws. On the other hand, the interpretation of those laws by the Treasury Department was a strained and unnatural one and was a departure from well-established precedent. That such interpretation was contrary to the intent of Congress is shown by the 1921 law in the most convincing way. For, in the last analysis, the problem of statutory construction resolves itself into a determination of the intent of the law-making body. How can such intent be determined better than from the express declaration of Congress itself?

It is clear from the foregoing discussion that, applying the rule that a re-enactment in similar language of an act which had previously received a *long continued* administrative construction, is to be considered as a legislative approval of such construction, the language of the 1917 and 1918 Acts should be construed as indicating no intent to tax the lending of stock, or the return of borrowed stock. The reenactment by Congress in the 1918 Act of the stamp tax provisions of the 1917 Act, under the circumstances disclosed herein, cannot be deemed to be indicative of a Congressional approval of Treasury Decision 2685. On the other hand, the express language of Congress, in the 1921 Act, definitely indicates the true intent of Congress not to tax the transactions in question.

POINT II.

THERE IS NO GROUND FOR INFERRING THAT CONGRESS INTENDED TO DISCRIMINATE AGAINST SHORT SALES OR TO IMPOSE A GREATER TAX ON "SHORT" THAN ON "LONG" TRANSACTIONS, NOR IS THERE ANY GROUND FOR ASSUMING THAT CONGRESS KNEW OF THE PRACTICE OF BROKERS TO BORROW AND RETURN STOCKS IN CONNECTION WITH SHORT SALES AND INTENDED TO TAX SUCH BORROWING AND RETURN.

The tax imposed by the 1917 Act, stripped of the various provisos and limitations, is

"On all sales or agreements to sell or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock in any association, company or corporation * * *"

The provisions of the 1918 Act are similar. The tax imposed by that Act is

"On all sales or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock or of profits or of interest in property or accumulations in any corporation, or to rights to subscribe for or to receive such shares or certificates * * *"

The obvious intent of these laws is to impose a tax upon sales of stock or upon such other transactions as partake of the nature of sales of stock.

The learned Court below held, however, that the language of the 1917 and 1918 Acts indicated a clear intent to impose a tax upon the lending of stock and the return of borrowed stock incident to short sales. To use the language of the Court (R. 16), "this, it seems to us is clearly what Congress regarded as a legitimate source of revenue."

The ruling of the Court of Claims confirms Treasury Decision 2685, under which, in connection with each short sale, it was necessary to pay a tax at least double and often three, four or five times the tax imposed on the long transactions.

The conclusion of the Court below is erroneous, because

(a) A short sale is merely a sale for future delivery, and the borrowing of stock is not essential to its execution. The custom of borrowing stock incident thereto is merely one of convenience among brokers, adopted to facilitate trading on the floor of the Stock Exchange. There is nothing to indicate that Congress was cognizant of this custom or intended to tax such transactions.

(b) There is no ground for assuming that Congress intended to impose a greater tax upon short transactions than that imposed upon long transactions. Short selling has been repeatedly found to be a beneficial and not a detrimental practice.

(c) There is nothing peculiarly speculative about a short sale which justifies the imposition of a prohibitive or discriminatory tax.

(d) Congress not having expressed a clear intent to tax the lending stocks and their return, the holding of the Court of Claims violates the well settled principle that a taxing act will not be extended by implication.

A.

A short sale is merely a sale for future delivery, and borrowing of stock is not essential to its execution. The custom of borrowing stock incident thereto is merely one of convenience among brokers, adopted to facilitate trading on the floor of the Stock Exchange. There is nothing to indicate that Congress was cognizant of this custom or intended to tax such transactions.

The learned Court below referred to the "indispensable requirement of an actual delivery of stock sold short by brokers"

(R. 17). The Court considered that the borrowing of stock was vital to the execution of a short sale, and that Congress may be deemed to have considered the lending to be a proper subject of tax.

A mere superficial study of the mechanism of a short sale indicates, however, that the borrowing of stock is not one of the essential steps in consummating a short sale. It is merely a convenient method adopted to facilitate the transaction of business on the Stock Exchange. From the point of view of the seller, there is nothing in the nature of a short sale which requires the borrowing of stock. He merely enters into a contract for the deferred delivery of a specified number of shares of a specified stock at a specified price, in the meantime securing the purchaser against loss by reason of the delayed delivery of the stock, by a deposit sufficient to cover any current increase in the market value of the stock. In other words, wholly apart from the operation of the Stock Exchange, a short sale could readily be consummated between two persons by a simple contract which would ultimately be consummated by a single delivery of stock and the payment of but a single tax thereon. There is nothing in the nature of a short sale which requires the borrowing of stock. A may sell short to B 100 shares of United States Steel stock. Selling short in such case would mean merely an agreement for future delivery, the purchaser being secured by a deposit of a sufficient sum of money pending such delivery. A, when he chose to make delivery, might purchase the stock from X and deliver it to B. The Government would, in such case, receive at most two taxes, one upon the purchase by A from X, and another upon the delivery from A to B.

In few cases does the customer, when he directs his broker to sell short, know that it is necessary for the broker to borrow the stock. The stock broker does not send a report to his customer of the borrowing of the stock, nor of the return of the borrowed stock, either during the continuation of or on the closing out of a short sale (Finding of Fact XIII; R. 8). The stock broker does not communicate with his customer

with reference to stocks loaned, borrowed or returned in connection with a short sale, and does not notify the customer in connection therewith (*id.*). Neither the lending nor the borrowing broker charges the customer any commission in connection with the lending or borrowing of the stock (Finding of Fact XIV ; R. 8).

Why then, if the borrowing of stock is not essential to the execution of a short sale (which in effect is nothing but a sale for deferred delivery), is it customary to borrow stock in connection with short sales? The answer is found in Rule 13 of the New York Stock Exchange (Finding of Fact VI ; R. 6), which provides that bids and offers made without stated conditions shall be considered to be in the "regular way" to wit, for delivery upon the business day following the contract. In other words, a simple transaction on the floor of the New York Stock Exchange, in the absence of stipulations to the contrary, calls for delivery on the following business day. Were it not for the tremendous volume of business done on the floor of the Stock Exchange each day, it would be simple enough to consummate a short sale by making a contract for delayed delivery. However, it has become the custom to make all sales in the "regular way" and arrange for the delayed delivery by the simple expedient of borrowing the stock from another broker to make delivery in the "regular way" until such time as the customer elects to close the transaction by "buying in" the stock and "covering" his short sale. With this more or less complicated procedure the customer has nothing to do. He knows only that he is "short" the specified number of shares of the specified stock, and that he is under the obligation to procure and deliver the stock in the future. It is a custom for the mutual convenience of brokers in transacting their business on the Stock Exchange, to make all sales in the "regular way." It is not, as we have seen, in any way vital to the transaction that there be a borrowing of stock. On the contrary, this is a more or less circuitous method of carrying out the transaction.

This phase of the transaction was carefully considered by Presiding Justice Ingraham of the Appellate Division of the Supreme Court of New York in his opinion in *Matter of Mills*, 139 App. Div. 55. In that opinion, in which he discussed the relation between a broker and his customer making a short sale, he said (p. 59) :

"It is true that the brokers are the agents of the customers in making the sale, but in such a transaction, as no property is acquired by the broker on behalf of his principal, the obligation of the customer depends entirely upon the contract by which he undertakes to supply to the broker upon a demand, a sufficient number of shares to make good his short sale. On the other hand, the broker undertakes that he will keep this transaction going on until such time as the broker demands from his customer a delivery of sufficient stock to complete the transaction or gives orders to purchase the stock to close the speculation. A failure on the part of either to perform this contract would give a cause of action against the party who has committed a breach, but it is evident that under such a transaction no property is acquired by either the broker or his customer, *and in procuring the stock to enable the customer to carry out his contract it would seem to follow that the broker does not act as the agent of the customer. With the details of the transaction the customer has no concern. Whether the stock is borrowed by the broker or not is quite immaterial to him. It is the broker's business to see to it that the person from whom he has borrowed the stock makes the necessary payment so as to keep the transaction between the lender and the borrower at the market value of the stock.* There is no distinction, as I can see, between a short sale of stock, or a sale of wool, or cotton, or other commodity; and while there is a different method under the rules of the various exchanges at which these short sales are made, it seems to me that the general principle as to the relation of broker and customer must apply.

In all cases of short sales made by a broker for a customer the broker necessarily assumes the obligation of obtaining the stock or other commodities for delivery if immediate delivery is necessary. The details by which the transaction is carried out are assumed by the broker when he makes such a contract, and with such details of the obligation assumed by the broker in carrying out the transaction the customer has nothing to do." (Italics ours.)

If the borrowing of stock is not a necessary concomitant to a short sale, and if it is merely a mechanical device invented to simplify transactions between members of the Stock Exchange, with which the customer is not concerned and of which he receives no notice, by what token can it be assumed that Congress, when it enacted the Stamp Tax Provisions of the War Revenue Acts (in which there is not a word about short sales or the borrowing and return of stock) knew of the internal workings of the Stock Exchange, and knew that it was customary to borrow stocks in connection with short sales? By what token can it be assumed that Congress intended to impose a tax upon such borrowings, a tax at least double and often three or four times that imposed upon ordinary long transactions? Is it not more likely that in framing the Tax Laws Congress knew nothing of the rules of the New York Stock Exchange and of the customs of brokers in connection with short sales?

B.

There is no ground for assuming that Congress intended to impose a greater tax upon short transactions than that imposed upon long transactions. Short selling has been repeatedly found to be a beneficial and not a detrimental practice.

A short sale, as we have indicated, is nothing more than the familiar sale for future delivery so common in all mercantile transactions.

To quote from Meeker, "The Work of the Stock Exchange" (p. 75) :

"In actual fact then, buying on margin is simply the financial phrase for buying stocks or bonds by employing credit to defer a payment of money ; the same basic operation is known as 'purchasing on credit' in some branches of commercial business. 'Selling short,' on the other hand, is simply the phrase used in finance to designate a sale of securities in which credit is used to defer their delivery ; in its economic essentials this operation corresponds to what merchants and manufacturers usually call selling 'for forward' or 'future delivery.' An investor or speculator who has bought stocks on margin is said to be 'long' of stocks ; whereas if he has sold them but has not yet delivered them, he is said to be 'short' of stocks" * * *

Thus Stock Exchange transactions, when stripped of the hectic and unfamiliar verbiage with which the financial scribe so often invests them, resolve themselves into a few commonplace and immemorial practices of trade which exist just as extensively, although unhonored and unsung, in every grocery store and newsstand in the nation."

Further on page 79 :

"We must next examine 'short selling' which involves the deferred delivery of stock.

The position of the man who sells stock short is fundamentally identical with that of the farmer who sells his crop before it is planted, or of the publisher who sells his newspapers months before the events which they will chronicle have even occurred. All these three sellers, by employing their credit and deferring the delivery of their goods, sell something which for the time being they do not own, but which they feel confident

they can obtain. All three owe goods instead of money, and all three must depend, to conclude their sales on credit, upon obtaining later the articles which they have sold—a task which may be either harder or easier than to obtain an equivalent sum of money.”

Apart from the rule of strict construction, and applying only common reasoning, what is there in the nature of a short sale which would justify the inference that Congress intended to discriminate against short sales?

There is nothing in the 1917 and 1918 Revenue Acts which suggests that there was any intention on the part of Congress to discriminate in any way between long and short sales. There is no suggestion that it was the policy of these laws to discourage short sales. The acts are purely revenue measures.

There is nothing in the nature of a short sale which suggests that there was any reason why Congress should impose a discriminatory and possibly a prohibitive tax upon such transactions. An examination of the debates of Congress either in connection with the enactment of the 1917 or 1918 laws or any earlier or subsequent taxing Act discloses nothing which suggests that there was any belief that short selling was economically or morally wrong or that there was anything in the practise which called for condemnation or restraint.

So far as the customer is concerned there is no substantial difference between a transaction in which he first buys stock and later sells it, and one in which he first sells and later buys stock. In one case the speculation is founded upon the belief and expectation that the market will rise; in the other, that it will fall.

A great deal has been written by economists on the practice of stock speculation, and particularly on the popular belief that the practice of short selling is detrimental to the interests of the public. It is a matter of common knowledge that

there is an under-current of popular feeling against those who sell short. History shows that from time to time there has been an agitation against this practice, and laws have been passed, prohibiting it, only to be later repealed when it was found that the prohibition was far more detrimental than the practice itself. A more extended study of the economic effects of stock speculation has in recent years borne out the truth that short selling has a most beneficial economic effect, and acts as a check against undue and dangerous inflation which must inevitably be followed by a sudden and demoralizing collapse.

Among those who have made a careful study of the economics of stock trading and of the practice of short selling, are Meeker, in his "The Work of the Stock Exchange," from which we have already quoted; Prof. Huebner, of the University of Pennsylvania, in his work entitled "The Stock Market," and William C. Van Antwerp, in a work entitled "The Stock Exchange from Within." These authorities are unanimous in their opinion as to the beneficial results flowing from the practice of short selling. Each of them discusses the popular belief to the contrary, and convincingly demonstrates the fallacy of that belief. We do not wish to burden the Court with extended extracts from these treatises in the body of this brief, but we feel that the discussions of short sales contained therein cannot but be illuminating upon the subject, and we have, therefore, added to this brief an appendix in which we have included excerpts therefrom, to which we respectfully refer.

It is interesting to note that probably the most searching investigation of stock speculation, to wit: the investigation made by a committee appointed by former Governor Charles E. Hughes of New York, resulted in a report from which the following is an extract:

"We have been strongly urged to advise the prohibition or limitation of short sales, not only on the theory that it is wrong to agree to sell that what one does not

possess, but that such sales reduce the market price of the securities involved. We do not think that it is wrong to agree to sell something that one does not now possess, but expects to obtain later. Contracts and agreements to sell, and deliver in the future, property which one does not possess at the time of the contract, are common in all kinds of business. The man who has 'sold short' must some day buy in order to return the stock which he has borrowed to make the short sale. Short sellers endeavor to select times when prices seem high in order to sell, and times when prices seem low in order to buy, their action in both cases serving to lessen advances and diminish declines of price. In other words, short selling tends to produce steadiness in prices, which is an advantage to the community. No other means of restraining unwarranted marking up and down of prices has been suggested to us."

Report of Committee on Speculation in Securities
and Commodities, June 7, 1909.

It has been held by this Court that a short sale of stock is not in any sense invalid, nor a violation of a statute against gambling contracts. This Court in *Clews v. Jamieson*, 182 U. S. 461, 489, quoted with approval the following statement of the rule with respect to such transactions announced in the earlier case of *Irwin v. Williar*, 110 U. S. 499, 508:

"The generally accepted doctrine in this country is, as stated by Mr. Benjamin, that a contract for the sale of goods to be delivered at a future day is valid, even though the seller has not the goods, nor any other means of getting them than to go into the market and buy them; but such a contract is only valid where the parties really intend and agree that the goods are to be delivered by the seller and the price to be paid by the buyer; and, if

under guise of such a contract, the real intent be merely to speculate in the rise or fall of prices, and the goods are not to be delivered, but one party is to pay the other the difference between the contract price and the market price of the goods at the date fixed for executing the contract, then the whole transaction constitutes nothing more than a wager, and is null and void."

The Court further said in the *Clews* case (p. 489) :

"In order to invalidate a contract as a wagering one, both parties must intend that instead of the delivery of the article there shall be a mere payment of the difference between the contract and the market price."

This principle was again affirmed by this Court in a unanimous opinion written by the late Chief Justice White in *Bond v. Hume*, 243 U. S. 15, 22.

Short sales of stock are obviously not gambling contracts, because, as indicated by the stipulated facts in this case, actual delivery is intended and takes place in every such transaction.

When a man bought a hundred shares of stock with the intention of selling again and did subsequently sell, a Federal tax of \$2 was paid on the purchase and a further tax of \$2 on the subsequent sale. When he sold short and later repurchased, under the law as enforced by the Internal Revenue officials, at least four separate taxes of \$2 each, and, as may often be the case, six, eight or ten or even more separate taxes were imposed, depending upon the number of times the stock was returned and reborrowed during the continuance of the short sale.

That the imposition of a plurality of taxes in short transactions acts as a deterrent does not admit of doubt. When it is considered that trading often involves turning over securities at a profit of only a fraction of one per cent. of their value, the multiplication of the ordinary tax twofold

and often three and fourfold reduces the possibility of profit to a large extent and so reduces also the incentive to trade on the short side of the market.

The effect of the imposition of the State and Federal stamp taxes has been to limit the activity of the "floor traders" who fill in the gaps between regular purchases and sales and trade for fractional profits. The activity of these traders, it has been pointed out by Meeker, tends to stabilize the market. As to the effect of the stamp tax upon these traders, he says (p. 104) :

"Thus, the imposition of these state and federal taxes upon sales of stock has placed a crushing burden upon the dealer in stocks who operates for small profits, and has led to abnormal and undesirable changes in the market's structure and methods of operation. To begin with, the number of floor traders has been reduced from over 200 to only about 50. Former floor traders have either sold their seats and retired from the Exchange entirely, or else have abandoned this particular work for some other more lucrative activity on the Exchange floor."

The tax is by no means a trifling one, and in the light of these circumstances the multiplication of the tax by two, three or four and even a larger multiple, in the case of short sales, might render the tax so onerous as to be prohibitive. This fact, we urge, is important upon the question of the intent of Congress. For unless Congress disclosed an intention to discriminate against short sales and to discourage such transactions, the logical interpretation of the law requires the holding that it was intended to tax both long and short transactions similarly.

This intent, as we have already pointed out, is convincingly indicated by the fact that under previous revenue acts of a similar nature no effort was made to construe the law as it has now been construed and enforced by the Internal Reve-

nue Bureau. If it had been the intent of Congress to impose additional taxes on short sales, Congress would certainly have indicated its intention by so amending the earlier laws as to make such intention clear and obvious. So, too, the construction of the 1917 and 1918 Acts made by the Commissioner of Internal Revenue has been indicated by Congress in the 1921 Revenue Act to be inconsistent with its policy, purpose and intent.

Surely no clearer indication can be found of the policy of Congress not to impose a larger tax on short than on long transactions, than the declaration of the Senate Finance Committee (Report No. 275, September 26, 1921), that the purpose of the proviso inserted in the 1921 Act was "to avoid double or multiple taxation." The inference from this statement, we insist, is irresistible that Congress never did intend to impose a double or multiple tax on short sales and that the Treasury Department instruction of the 1917 and 1918 laws was not consistent with the policy of Congress, nor with its intent as expressed in those Acts.

C.

There is nothing peculiarly speculative about a short sale, which justifies the imposition of a prohibitive or discriminatory tax.

The learned Court below, in its opinion said (R. 12) :

"The transaction is obviously speculative, and in so far as its consummation is concerned, the customer X is not a party to the agreement between Y and M."

Further (R. 14-15) :

"Selling short, as previously observed, is entirely a speculative transaction. One who sells short through a broker hazards a bargain on the decline of the market value of the stock sold."

It is quite apparent from the foregoing, that the learned Court below based its decision, in part at least, upon the thesis that a short sale is a peculiarly speculative transaction, differing from other stock transactions in that respect to such an extent that it was a "legitimate source of revenue" (R. 16), even though taxed at twice, four times or even a greater number of times the amount of the tax imposed upon long transactions.

Concededly, a short sale is a speculative transaction, but is there any suggestion in the language of the statute that Congress intended to impose a multiple tax on short transactions because of their speculative character, while at the same time imposing but a single tax upon long transactions?

We respectfully urge that there is nothing in a short sale which makes it more speculative than a long purchase, and that Congress did not intend to impose a tax upon transactions which were speculative in their nature. The Acts in question were purely revenue measures and were in no sense aimed at discouraging speculation.

(a) As between the brokers who alone are parties to the borrowing and return of stock, the transaction is not speculative.

We have seen that the motive of the seller is a matter of no concern to the broker. A short sale of stock is defined as "a sale or contract for the sale of stock which the seller does not deliver to the broker who is employed to make the sale" (Finding of Fact III; R. 6). As we have already indicated, a short sale may be made necessary by the fact that the seller, although owning the stock, cannot make immediate delivery thereof to his broker. A short sale may also be made necessary where the stock is not in proper deliverable condition. Most frequently, of course, an order to sell short is given with the idea on the part of the seller that he will be able to make delivery by a subsequent purchase at a lower price.

The broker's intention in every case is merely to sell in such manner that his customer may make delivery in the future, i. e. "cover" his short sale. Because of the peculiar rule of the Stock Exchange, requiring delivery to be made, unless otherwise specified, on the following business day, it has become the custom to borrow stocks sold short, and to make delivery to the purchaser.

The borrowing is in no sense speculative. It is difficult to conceive of any transaction which is less speculative in its nature. When the loan of stock is made, the broker borrowing the stock must deposit the full market price with the broker lending the stock as security, and during the continuation of the loan the sum in the hands of the broker lending the stock is kept, by payments back and forth between the two brokers, at the market price of the stock as it fluctuates (Finding of Fact; R. 7). There is no element of risk whatsoever on the part of either broker, in connection with the lending of stock. Either broker may close the transaction at any time upon demand. The broker lending the stock will receive back an exactly equivalent amount of the same stock, and the broker borrowing the stock will receive back the money deposited with the lending broker, with interest.

(b) With respect to the customer, the speculative nature of the transaction is not created or enhanced by the borrowing and return of the stock.

As we have demonstrated, the borrowing of stock is not essential to the execution of a short sale; it is merely a practice which has grown up among brokers for their own convenience and to facilitate transactions on the floor of the New York Stock Exchange. In its simplest form, a short sale could be readily effected by a contract for the future delivery of the stock. The speculation which the short seller undertakes is one inherent in the nature of the sale, and is neither created nor enhanced by the peculiar method adopted by brokers for carrying it out. If a short sale were made

in its simplest form, i. e., by procuring a purchaser who agreed to accept deferred delivery of the stock, only two taxes at most, would be paid, one upon the purchase by the seller, of an equivalent amount of stock for delivery to the buyer, and another upon the transfer thereof to the latter. Whatever speculation exists in connection with such a transaction, arises out of the necessity of making delivery in the future. That risk would be assumed by the seller even though no stock were borrowed and none returned.

(c) *"Short" selling is no more speculative than "long" buying.*

A careful study and analysis of the various kinds of stock transactions makes it difficult to understand how the learned Court of Claims could have conceived that there was something *peculiarly* speculative about a short sale. In what respect is a short sale more speculative than a long transaction? To paraphrase the language of the learned Court below, does not one who purchases stock on margin likewise "hazard a bargain" on an anticipated change in the market value of the stock purchased? In the latter case the customer hopes for an advance in price out of which he will derive a profit. In the case of a short sale the customer hopes for a decline in price. Is there anything less speculative in hazarding a bargain on an advance than in a similar hazard on a decline? We have called attention to the most useful economic effect of the practice of selling short—how it operates as a brake or check upon excessive advance and inflated and artificial prices. But, apart from its economic usefulness, what is there more speculative about a short sale than there is about other commonly accepted everyday commercial practices? Does not a manufacturer who contracts for the future sale and delivery of commodities which he may not have manufactured, and for which he may not even have purchased the raw materials, "hazard a bargain" on the prices of labor and materials? Does not a farmer who sells his crops before they are harvested, and possibly before they

are planted, similarly "hazard a bargain" on the market? We might suggest innumerable instances of similar speculative transactions, none of which have been singled out by Congress as an object of special attention or as a special subject of taxation because of its speculative nature.

We are not endeavoring in this discussion, to question the correctness of the Court's statement that a short sale is a speculative transaction. Concededly it is, but we do emphatically urge that in enacting the provisions of the Revenue Acts of 1917 and 1918, to which this action relates, Congress did not, as the learned Court of Claims found, intend to tax the borrowing and return of stocks incident to short sales because of the speculative nature of the transactions, and we claim that there is nothing in the Acts of 1917 and 1918 which indicates that Congress had such transactions in mind at all, or intended to tax them because of their speculative nature.

If Congress intended to discourage speculation, or to single out speculative transactions as a special subject of taxation, it singularly failed of its purpose. Among other forms of speculation, and particularly stock speculation, none is more speculative than a so-called "put" or a "call," all of which are familiar forms of speculation in stock but which frequently do not result in the delivery or transfer of a single certificate of stock, being in effect merely options which may or may not be exercised.

A "put" is defined as an instrument issued by a person giving the holder thereof the right to "put" or deliver to the subscriber a certain number of shares of a specified stock at a specified price within a specified time from the date thereof. A "call" is a similar instrument which gives the holder the privilege of demanding the number of shares of stock specified therein at a specified price, within a specified time. (Todman, Wall Street Accounting, pp. 73, 75.)

Neither of the foregoing transactions, although purely speculative in character, is subject to tax as such. When a put or call does result in the delivery of stock by reason of the exercise of the option of the holder thereof, only a single

tax is imposed. Comparing the tax in such case with the four, six, eight or even more taxes which must be paid, according to the Government's contention, in the case of each short sale, surely we are justified in saying that Congress signally failed of its purpose, if, as the Court below indicated, it considered the speculative nature of such stock transactions a proper ground for multiple taxation.

D.

Congress, not having expressed a clear intent to tax the lending of stocks and their return, the holding of the Court of Claims violates the well settled principle that a taxing act will not be extended by implication.

The rule that the provisions of a taxing act are not to be extended by implication, is too familiar to require the extended citation of authority.

This Court has repeatedly applied that rule in construing statutes imposing taxes.

In *United States v. Field*, 255 U. S. 257, this Court construed the provisions of the Revenue Act of 1916, which imposed a tax "upon the transfer of the net estate of every decedent dying after the passage of this Act." It was provided, in Section 202, that "the value of the gross estate of the decedent shall be determined by including the value at the time of his death, of all property, real or personal, tangible or intangible, wherever situated." * * * The Treasury Department, in its regulations, construing the foregoing provision, ruled:

"Property passing under a general power of appointment is to be included as a portion of the gross estate of a decedent appointer."

This Court, again applying the familiar rule that a taxing act cannot be extended by implication, declined to follow the construction of the Treasury Department. Mr. Justice Pit-

ney, reading the unanimous opinion of the court, said (p. 262) :

"Applying the accepted canon that the provisions of such acts are not to be extended by implication (*Gould v. Gould*, 245 U. S. 151, 153) we are constrained to the view—notwithstanding the administrative construction adopted by the Treasury Department—that the Revenue Act of 1916 did not impose an estate tax upon property passing under a testamentary execution of a general power of appointment."

Further in the opinion, Mr. Justice Pitney said (p. 264) :

"It would have been easy for Congress to express a purpose to tax property passing under a general power of appointment exercised by a decedent, had such a purpose existed; and none was expressed in the Act under consideration."

In the case of *Gould v. Gould*, 245 U. S. 151, above referred to, the question raised was whether alimony received by a wife from a divorced husband was "income" within the meaning of the Income Tax Act of 1913. This Court held that it was not. Mr. Justice MacReynolds said (p. 153) :

"In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government and in favor of the citizens."

Similarly, in *United States v. Merriam*, 263 U. S. 179, it appeared that in a will certain bequests were made, among others, to three persons whom we will call X, Y and Z. The said X, Y and Z were named as executors and trustees, with

a provision that the bequests therein made to them be in lieu of all compensation and commissions to which they would *otherwise* be entitled as executors and trustees. The question was whether such bequests were income taxable under the Income Tax Act of 1913. This Court unanimously held that they were not, even though the bequest may have been made in lieu of compensation for services as executors and trustees, applying again the familiar canon of construction that laws imposing taxes "*are not to be extended by implication beyond the clear import of the language used.*" (*Italics ours.*)

There is nothing in the 1917 and 1918 Acts which expressly imposes a tax upon the lending of stock or the return of borrowed stock. The language of Congress indicates simply an intent to tax sales and similar transactions involving a transfer of legal title. The holding of the Court of Claims is clearly an extension of the tax to a transaction not expressly included in the statute, and therefore violates the canon of construction above referred to.

A correct application of the principle for which we contend is found in the holding of the Appellate Division of the New York Supreme Court, in the case of *Travis v. American Cities Co.*, 192 App. Div. 16. That case involved the construction of a New York statute imposing a tax upon transfers of stock similar to, but far broader in its scope, than the 1917 and 1918 Federal Acts. The tax imposed by the New York statute was upon all deliveries "whether intermediate or final, and whether investing the holder with the beneficial or legal title to said stock, or merely with the possession or use thereof for any purpose, or to secure the future payment of money, or the future transfer of any stock." The defendant corporation, desiring to issue bonds, executed a trust mortgage and deposited with the Guaranty Trust Company thereunder, certain stocks of other corporations as security for the payment of principal and interest on the bonds to be issued. The defendant corporation was to be entitled to receive dividends declared on the stock, and

otherwise to receive the benefits thereof. The Court held that such transfer was not taxable under the New York statute, in spite of the fact that its provisions were far broader in their scope than the Federal Act. Mr. Justice Merrell, writing the unanimous opinion of the Court, said (p. 29):

"In the absence of a clear legislative intention to impose the tax for which the Comptroller contends in the case at bar, I do not think we should hold that the transfer of the shares in question was subject to tax.

A further ground for denying the right to impose a tax under said statute lies in the well-established principle that laws relating to taxable transfers must show a clear legislative intention to tax. * * * A statute levying a tax should be construed most favorably to the tax payer, the government being entitled to no rights thereunder, *except those clearly given by its language.*

A careful examination of the statute leads me to the conclusion that the Legislature did not intend that transfers of stock under the circumstances of the case presented here were subject to tax." (*Italics the Court's.*)

The learned Court of Claims referred, in its opinion, to the cases of *Travis v. Ann Arbor Co.*, 168 N. Y. S. 53 (the official citation is 180 App. Div. 799), and *Bonbright & Co. v. State of New York*, 151 N. Y. S. 35, (the official citation is 165 App. Div. 640). These cases were cited by the learned Court of Claims as a precedent for its holding that the lending and return of stocks were properly taxable under the 1917 and 1918 Acts. The Court laid special emphasis upon the fact that the Federal Acts of 1917 and 1918 contained a clause "whether entitling the holder in any manner, to the benefit of such stock or not," and that the New York statute contained a similar clause.

The two cases referred to will be found, however, to involve transfers of legal title. In the *Bonbright* case the transfer was to a trustee who was expressly vested with legal title although the beneficial title or ownership was in others.

The transfer to the trustee was held to be taxable under the broad terms of the New York statute. We are quite willing to concede that such a transfer to a trustee would be taxable even under the much narrower language of the Federal statute. Such concession can be of no avail to the Government, for the lending of stock has none of the characteristics of a transfer of legal title to a trustee.

The case of *Travis v. Ann Arbor Co.*, *supra*, likewise involved a transfer of legal title, the only question being whether it made any difference that such transfer was for the accommodation of another. The case cannot be cited as authority for the imposition of a tax upon a transaction which does not involve a transfer of legal title.

The Court, in citing those two cases, erred in saying that "revenue legislation, in every essential respect similar to the laws here involved, were considered by the Court, and the issue was precisely as it is here."

It is clear from the foregoing discussion that the Court below misconceived the nature of the transactions involved in this case, and that the Court erred in holding that it was the intent of Congress to single out the lending of stock and the return of borrowed stock as a special source of taxation to an extent greater than similar long transactions. There is nothing in the nature of a short sale which necessarily calls for the borrowing of stock. The custom of brokers to borrow stock in connection with such transactions is merely one of convenience. Nor is there anything about a short sale which is peculiarly speculative, as the Court below held. On the contrary, a short sale is no more speculative than dozens of other ordinary mercantile transactions. A study of the economic effects of a short sale indicates that it is a beneficial and not a detrimental practice. The holding of the learned Court below extending the operation of the 1917 and 1918 Acts, violated the well-settled principle that a taxing act is not to be extended by implication, and such extension was neither warranted by the language of the

Act, by the nature of the transactions, nor by any possible reason which Congress may be said to have had for discriminating against such transactions.

POINT III.

THE TRANSACTIONS INVOLVED IN THIS CLAIM ARE NOT TAXABLE UNDER THE ENACTING CLAUSES OF THE 1917 AND 1918 ACTS.

This action, involving as it does, the construction of a statute imposing a tax, calls into operation the rule of strict construction to which we have referred in our preceding point. This rule has been uniformly applied by this Court, but was disregarded by the learned Court below.

The War Revenue Acts of 1917 and 1918 are laws which impose a tax and as such they must be strictly construed and no tax can properly be collected thereunder unless such tax comes clearly within the provisions of those laws. If there is any ambiguity, such ambiguity must be resolved in favor of the taxpayer, for the rule of strict construction of such statutes is a fundamental rule.

The Enacting Clause.

The enacting clause of the 1917 Act reads as follows:

“Capital stock, sales or transfers: On all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock in any association, company, or corporation, whether made upon or shown by the books of the association, company, or corporation, or by any assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock or not * * *.”

The enacting clause of the 1918 Act reads as follows :

"Capital stock, sales or transfers: On all sales, or agreements to sell, or memoranda of sales or deliveries of, or transfers of legal title to shares or certificates of stock or of profits or of interest in property or accumulations in any corporation, or to rights to subscribe for or to receive such shares or certificates, whether made upon or shown by the books of the corporation, or by an assignment in blank, or by any delivery, or by any paper or agreement or memorandum or other evidence of transfer or sale, whether entitling the holder in any manner to the benefit of such stock, interest, or rights, or not * * *."

A.

The word "deliveries" as used in the 1917 and 1918 Acts, cannot be held to apply to every transfer of physical possession. It must be construed in the light of its context, and as so construed must be limited to sales and other similar transfers of legal title.

It is only by giving the word "deliveries" its broadest meaning that the learned Court of Claims was able to hold that the lending of stock among brokers and the return of such borrowed stock were taxable under the 1917 and 1918 Acts.

Our contention is that that word must be construed as being applicable to deliveries in connection with sales or similar transactions which come within the scope of the other language used in the enacting clause.

It is true that the transactions which were taxed and which were the subject matter of this claim were physical deliveries and transfers of certificates of stock. But that there was no intention to tax every physical transfer or delivery of stock is evident, for the law has never been construed as requiring the payment of a tax upon the delivery

of stock to a bank or trust company for safe keeping, nor is it conceivable that any such tax could have been intended by Congress. If it were intended to tax every physical transfer or delivery of stock, a tax would have been required on the mere delivery of a certificate of stock to a messenger or an express company for delivery to another. Such construction would require the payment of a tax upon every change of physical possession of a certificate of stock.

It must be clear from the foregoing that the provisions of the law to which we refer, were not intended to apply to every delivery of stock regardless of the purpose of the delivery.

Although the facts indicate that there was a delivery of certificates of stock in each of the transactions involved in this claim, such delivery is not controlling, nor does it establish any proper basis for declaring the law to be applicable by reason thereof, for the mere physical delivery is quite apparently not the essence of a taxable transfer, and the fact of delivery of itself does not warrant the conclusion that such delivery constituted a transfer which was taxable under these laws.

Apart from the rule of strict construction in favor of the taxpayer, to which we have already referred, the rule of *ejusdem generis* must be applied in construing the language of these taxing acts. The application of this rule to statutory construction is so firmly fixed as to be almost mandatory. Its application requires that when statutory words of specific purport are followed by words of general purport, the application of the latter is confined to the subject matter embraced in the former, and limited in their effect by the specific words to which they are joined.

The rule is well stated in *State v. Walsh*, 43 Minn. 444:

"It is a principle of statutory construction everywhere recognized and acted upon, not only with respect to penal statutes but to those affecting only civil rights and duties, that where words particularly designating specific acts or things are followed by and associated

with words of general import comprehensively designating acts or things, the latter are generally to be regarded as comprehending only matters of the same kind or class as those particularly stated. They are to be deemed to have been used, not in the broad sense which they might bear if standing alone, but as related to the words of more definite and particular meaning with which they are associated."

The rule of *ejusdem generis* is really a corollary to the maxim *noscitur a sociis*, which is of uniform application in the construction of statutes. Under this maxim, where two or more words are grouped together and have ordinarily a similar meaning, but are not equally comprehensive, they will qualify each other when associated and the sense of particular words may be greatly influenced by their context.

The reports abound with cases which apply the rule of *ejusdem generis* and the maxim *noscitur a sociis* to limit the broad meaning of a word of general import, in precisely the same manner as we say the word "deliveries" should be limited in the acts under discussion.

For example, in *Holy Trinity Church v. United States*, 143 U. S. 457, this Court had occasion to construe an Act of Congress which made it unlawful for any person or corporation to prepay the transportation or encourage the importation of any alien or foreigner into the United States under a contract to perform labor or service of any kind in this country. In a separate section certain specific exceptions were enumerated, among them professional actors, artists, lecturers, singers and domestic servants. The question arose whether a church procuring a rector from England violated the Statute. The Court held that notwithstanding the general words of the statute and the express exceptions which did not include the contract in question, such services were not within the intent of the statute. The learned discussion by Mr. Justice Brewer in that case, is particularly appropriate to the present case. Mr. Justice Brewer said (p. 458) :

"It must be conceded that the act of the corporation is within the letter of this section for, the relation of rector to his church is one of service, and implies labor on the one side with compensation on the other. Not only are the general words labor and service both used, but also, as it were to guard against any narrow interpretation and emphasize a breadth of meaning, to them is added "of any kind;" and, further, as noticed by the Circuit Judge in his opinion, the fifth section, which makes specific exceptions, among them professional actors, artists, lecturers, singers and domestic servants, strengthens the idea that every other kind of labor and service was intended to be reached by the first section. While there is great force to this reasoning, we cannot think Congress intended to denounce with penalties a transaction like that in the present case. It is a familiar rule, that a thing may be within the letter of the statute and yet not within the statute, because not within its spirit nor within the intention of its makers. This has been often asserted, and the reports are full of cases illustrating its application. This is not the substitution of the will of the judge for that of the legislator, for frequently words of general meaning are used in a statute, words broad enough to include an act in question, and yet a consideration of the whole legislation, or of the circumstances surrounding its enactment, or of the absurd results which follow from giving such broad meaning to the words, makes it unreasonable to believe that the legislature intended to include the particular act. As said in *Plowden*, 205: 'From which cases, it appears that the sages of the law heretofore have construed statutes quite contrary to the letter in some appearance, and those statutes which comprehend all things in the letter they have expounded to extend to but some things, and those which generally prohibit all people from doing such an act they have in-

terpreted to permit some people to do it, and those which include every person in the letter, they have adjudged to reach to some persons only, which expositions have always been founded upon the intent of the legislature, which they have collected sometimes by considering the cause and necessity of making the act, sometimes by comparing one part of the act with another, and sometimes by foreign circumstances'."

In *Virginia v. Tennessee*, 148 U. S. 503, this Court was called upon to construe the constitutional provision that "no state shall, without the consent of Congress, levy any duty on tonnage, keep troops or ships of war in time of peace, *enter into any agreement or compact with another State*, or with a foreign power, or engage in war, unless actually invaded, or in such imminent danger as will not admit of delay."

Mr. Justice Field said (p. 517) :

"The terms 'agreement' or 'compact' taken by themselves are sufficiently comprehensive to embrace all forms of stipulation, written or verbal, and relating to all kinds of subjects; to those to which the United States can have no possible objection or have any interest in interfering with, as well as to those which may tend to increase and build up the political influence of the contracting States, so as to encroach upon or impair the supremacy of the United States or interfere with their rightful management of particular subjects placed under their entire control. * * * If, then, the terms 'compact' or 'agreement' in the Constitution do not apply to every possible compact or agreement between one State and another, for the validity of which the consent of Congress must be obtained, to what compacts or agreements does the constitution apply? We can only reply by looking at the object of the constitutional provision, and construing the terms 'agreement' and 'compact' by

reference to it. It is a familiar rule in the construction of terms to apply to them the meaning naturally attaching to them from their context. *Noscitur a sociis* is a rule of construction applicable to all written instruments. Where any particular word is obscure or of doubtful meaning, taken by itself, its obscurity or doubt may be removed by reference to associated words. And the meaning of a term may be enlarged or restrained by reference to the object of the whole clause in which it is used."

A New York statute authorized the people to bring an action to recover "money, funds, credits and property" which might have been improperly obtained and disposed of by certain corporations. The Court of Appeals in *People v. New York & Manhattan Beach Railway Co.*, 84 N. Y. 565, construing this statute, held that although the language, literally construed, was broad enough to cover real property, a proper construction of the law required a holding that such property was not included within its scope. The Court said (p. 568) :

"The word *property* describes any estate whether goods, money or lands, and in its general signification includes any thing capable of ownership. But the meaning of a statute is to be found by comparing all its parts, and particular words may be limited if on such comparison it appears that they were used in a limited or restricted sense. * * * It is to be observed that the word *property* follows the enumeration of specific kinds of personal property. The words are 'money, funds, credits and property.' If it had been intended that the statute should have applied to all property, real and personal of a municipal or other public corporation, obtained without right, these general and comprehensive words would naturally have been used. The word prop-

erty associated as it is with the preceding words of specific description, is to be construed as referring to property of the same general kind with that previously enumerated upon the maxim *noscitur a sociis*."

In *United States v. Standard Brewery, Inc.*, 251 U. S. 210, this Court had occasion to construe the War-time Prohibition Act which prohibited the use of grains, fruits and other food products in the manufacture of "beer, wine or other intoxicating malt or vinous liquors for beverage purposes" until the conclusion of the war. The Government contended that the act included within its scope beer and wine, whether intoxicating or not. This Court rejected the Government's contention and limited the application of the Act to *intoxicating* beer and wine only. Mr. Justice Day said (p. 218) :

"So here, we think it clear that the framers of the statute intentionally used the phrase 'other intoxicating' as relating to and defining the immediately preceding designation of beer and wine. 'As a matter of ordinary construction, where several words are followed by a general expression as here, which is as much applicable to the first and other words as to the last, that expression is not limited to the last, but applies to all.' Lord Bromwell in *Great Western Ry. Co. v. Swindon, etc., Ry. Co.*, L. R. 9 App. Cas. 787, 808."

Sutherland, in his treatise on statutory construction, (2 Sutherland Statutory Construction (2nd edition) page 707), quoting from *International Trust Company v. American Loan & Trust Company*, 62 Minn. 501, 503, states the principle of statutory construction as follows:

"It is always an unsafe way of construing a statute or contract to divide it, by a process of etymological dissection, into separate words, and then to apply to each thus separated from its context, some particular

definition given by lexicographers, and then reconstruct the instrument upon the basis of these definitions. An instrument must always be construed as a whole and the particular meaning to be attached to any words or phrase is usually to be ascertained from the context, the nature of the subject treated of, and the purpose or intention of the parties who executed the contract, or of the body which enacted or framed the statute or constitution."

Applying the foregoing rule, the Court, in *Mackall v. District of Columbia*, 16 App. Cas. (D. C.) 301, construing a statute which forbade the sale without a license, of "whiskey, brandy, rum, gin, wine, ale, porter, beer and all other fermented and distilled liquors," held that the general words applied only to such liquors as were ordinarily used as intoxicants and not to such as were used for medicinal or other purposes.

There are several instances in the reports where the word "delivery" used in a statute, has been held not to include every physical transfer.

In the English bankruptcy act of 1849, the terms "gift, delivery or transfer" were used in defining an act of bankruptcy. In construing this act it was held in *Isitt v. Beeston*, L. R., 4 Exch. 159, 161:

"In order that a delivery of goods should amount to an act of bankruptcy it must be a delivery conveying or purporting to convey an interest in the goods."

In *Cotton v. James*, 1 Moody & Malkin 273, 277, Lord Tenterden, construing a similar provision in an earlier bankruptcy act, said:

"The word 'delivery' is one certainly of very general signification, but standing as it does in the statute (6 G. 4 c. 16 s. 3) connected with the words 'gift or transfer,'

I incline to think it must be confined in interpretation to transactions of the same nature."

In 2 Sutherland, Statutory Construction (2nd edition), pages 759 et seq., is to be found a collection of typical instances in which Courts, in construing statutes, have departed from a strict and literal meaning of a word or phrase and have given it a broader or narrower, or even different, meaning in order to conform to the apparent intent of the legislature. A few of the many examples of such statutory construction cited by Sutherland are the following:

The word "city" in a constitutional provision as to the use of streets, was held to include a town (*Pereria v. Wallace*, 129 Cal. 397). But in an act authorizing cities to appropriate money for the celebration of certain holidays, it was held that the word "cities" was used in a restricted sense and did not include towns (*Day v. Morristown*, 62 N. J. L. 571).

The word "gift" was held not to include a gift causa mortis (*Thomas v. Lewis*, 89 Va. 1).

In a statute authorizing actions for wrongful death the term "heir or heirs" was held to include a child or children but not collateral heirs or relatives. (*Hindry v. Holt*, 24 Colo. 464).

The word "peddler" was held not to include a book canvasser (*Emmons v. Lewistown*, 132 Ill. 380).

In construing a statute imposing a penalty upon any person who should displace, remove, injure or destroy any rail, sleeper, switch, bridge, viaduct, culvert, embankment or structure attached or appurtenant to or connected with any railroad, it was held that the word "structure" did not include a fence (*State v. Walsh*, 43 Minn. 444). On the other hand, under a statute authorizing an injunction to restrain the erection of any structure intended to spite, injure or annoy an adjoining proprietor, it was held that a fence was a structure within

the meaning of the statute. (*Karasek v. Peier*, 22 Wash. 419.)

In addition to the cases cited by Sutherland, there are numerous other instances where Courts have refused to take the literal meanings of words contained in the statute but have sought the intention of the legislature, even though, in extreme cases, such course lead to a construction different from, and often contrary to, the literal meaning.

Applying the rule of statutory construction, exemplified in the foregoing authorities, we earnestly urge that the word "deliveries" upon which the Government so strongly relies as justifying the imposition of the tax on the lending of stock and the return of borrowed stock, must be construed, not according to its literal meaning, but in the light of its context, and as so constructed it cannot be deemed to indicate a purpose on the part of Congress to tax such transactions.

B.

The lending of stock, as practised by brokers, does not constitute a transfer of legal title. The relation between the lending broker and borrowing broker is that of pledgor and pledgee. The transaction being a pledge, there is no transfer of title.

We have indicated in the preceding subdivision of this point that the word "deliveries" is associated with the terms "sales of stock" and "transfers of legal title to shares or certificates of stock," and that its meaning is to be determined from such association.

Counsel for the Government argued that the lending of stock constitutes a transfer of legal title thereto, and hence was properly taxable under the 1917 and 1918 Acts. Counsel for the Government, in so arguing, took a position entirely inconsistent with that taken by the Treasury Department under the 1914 Act, as we have indicated by reference to Treasury Decision 2182, in which decision the Treasury De-

partment had, in effect, accepted the proposition that the lending of stock "does not represent a change of ownership." The present contention of the counsel for the Government is, therefore, a complete reversal of position.

The Court below, nevertheless, held that the lending of stock constitutes a transfer of legal title.

We earnestly contend that the learned Court below fell into error in reaching that conclusion. That conclusion was predicated solely upon the fact that the broker borrowing the stock is able to use the same to make delivery thereof to the purchaser, and that the purchaser receives good title thereto.

The Court considered the power of the borrowing broker to transfer title to be the vital and controlling element of the transaction, and came to the conclusion that his ability to transfer good title to the purchaser presupposed a transfer of title from the lending broker to him "*irrespective of the agreement between the parties as to the reciprocal rights and obligations growing out of the transaction*" (R. 15). (Italics ours.)

The logic of this statement is clearly fallacious in so far as it applies to the present case. We respectfully insist that the question of whether there is a transfer of ownership cannot be determined without giving due effect to the terms and conditions of the agreement between the parties and the reciprocal rights and obligations growing out of the transaction. To hold that there is a transfer of title or ownership irrespective of the terms and conditions of the agreement between the parties is, to use a homely expression, "putting the cart before the horse."

We can no more close our eyes to the agreement between the parties, in determining the question as to the transfer of title or ownership, than we can, in the case of any other contract, determine the nature of the transaction without giving due effect to the agreement between the parties and the reciprocal rights and obligations growing out of the agreement. That agreement alone is the criterion by which the legal

nature of the transaction is to be determined. The effect of the holding of the learned Court below is to give a dual nature to the transaction between the borrowing and lending brokers; on the one hand, according to the opinion of the Court, there is a transfer of ownership; on the other hand, according to the agreement between the parties, there is a retention of ownership on the part of the lending broker, and of all the rights and privileges of ownership of the securities loaned and of all the burdens attaching to such ownership. That agreement shows that the loss occasioned by a decline in the value of the securities loaned remains with the lending broker. A gain caused by their increase in value is a gain to the lending broker. The lending broker receives the benefit of all dividends and is subject to all burdens, in the form of assessments, or otherwise, incident to the ownership thereof. The lending broker may at any time call for the return of his securities, and the borrowing broker is under the legal obligation to return them on demand.

The theory of the learned Court below was that these reciprocal rights and obligations were purely contractual and could not affect its conclusion that ownership of the securities passed to the borrowing broker. We respectfully urge that, as a legal proposition, the terms of the agreement between the brokers, and the reciprocal rights and obligations created thereby, cannot be ignored and cannot be dissociated from the question whether legal title does or does not pass.

The learned Court below endeavored to supplement its conclusions by reference to the fact that as between the corporation issuing the stock and the brokers dealing therein, the ownership of the stock vests in the purchaser. This statement is not strictly accurate and is not borne out by the agreed statement of facts. The most that can with accuracy be said is that the borrowing broker, or the purchaser, or any subsequent transferee, may cause the certificates so transferred to be registered in his name on the books of the corporation, and that when so registered he would be deemed by the corporation to be the owner thereof.

Certificates of stock dealt in by brokers are in every case endorsed in blank. The name of the person appearing upon the face of the certificate is necessarily some prior holder thereof. As between the corporation and the rest of the world the person whose name appears on the certificate is the owner thereof. A certificate of stock may, however, be repeatedly sold, borrowed, returned, pledged, or otherwise dealt in dozens of times before there is any record on the books of the corporation of a change of ownership. The right of the holder of a certificate properly endorsed by the registered holder to have the same transferred to his own name on the books of the corporation cannot in any sense determine the actual title thereto, for obviously a pledgee may, if he chooses, procure the certificates of stock pledged with him to be so transferred on the books of the corporation, although no one will contend that a pledgee has title thereto as against the pledgor.

On the other hand a person who has long since parted with actual title to the stock may still be the registered holder thereof on the books of the corporation and be entitled to the benefits of such ownership. A common example of this situation is found when stocks are sold "ex dividend." This occurs when a corporation has declared a dividend payable to stockholders of record on a specified date. As between the corporation and all other persons, the registered holder of the stock on the dividend date is entitled to and will receive the dividend irrespective of the fact that he may have parted with actual title thereto before the dividend is paid. Sales subsequent to the dividend date are made "ex dividend" and the price reflects the fact that the seller, as between himself and the corporation, is still considered to be the owner of the stock, although as a matter of fact he has parted with title thereto.

It appears, therefore, from the foregoing that no aid can be derived, in determining whether or not title has been transferred, from the fact that the corporation recognizes one

person or another as the owner of the stock. The sole test of ownership, we insist, is the agreement between the parties; and the fact that the corporation recognizes some other person as the owner gives no aid whatsoever in determining the question.

The fallacy in the Court's conclusion that there has been a transfer of title from the lending to the borrowing broker lies in the erroneous premise that there must be an unbroken chain of title in order that the borrowing broker may transfer such title to the purchaser. The Court fails to give due weight to the rule that certificates of stock partake of the nature of negotiable instruments, and that the holder of a certificate of stock, endorsed in blank, may transfer good title thereto even though he himself had not acquired title. In this respect certificates of stock are *sui generis*, and any conclusion based upon reasoning which ignores this principle of law cannot be sound.

It has long been the rule that where one entrusts to another certificates of stock, endorsed in blank, even though not parting with title thereto, he will be estopped from asserting his title as against another who may have acquired the same in good faith and for value. Thus a *bona fide* purchaser for value of certificates of stock endorsed in blank acquires good title thereto, under principles of the common law, and wholly apart from statute, even though the vendor may not himself have had good title thereto.

In *McNeil v. The Tenth National Bank*, 46 N. Y. 325, the Court said (p. 329) :

"It must be conceded, that as a general rule, applicable to property other than negotiable securities, the vendor or pledgor can convey no greater right or title than he has. But this is a truism predicable of a simple transfer from one party to another where no other element intervenes. It does not interfere with the well-established principle, that where the true owner holds out another, or allows him to appear, as the owner of, or as having

full power of disposition over the property, and innocent third parties are thus led into dealing with such apparent owner, they will be protected. Their rights in such cases do not depend upon the actual title or authority of the party with whom they deal directly, but are derived from the act of the real owner, which precludes him from disputing, as against them, the existence of the title or power which, through negligence or mistaken confidence he caused or allowed to appear to be vested in the party making the conveyance."

The Court held, applying the foregoing rule, that an innocent purchaser or pledgee of a certificate of stock endorsed in blank, acquired good title thereto as against the true owner who had entrusted possession thereof to the wrongful seller or pledgor.

Similarly, in *Knox v. Eden Musee Co.*, 148 N. Y. 441, the Court said (p. 454) :

"The principles applicable to negotiable paper have been extended to embrace public debentures payable to bearer, and bonds of corporations, and some of the incidents of negotiability have either by custom or statute been applied to instruments not strictly negotiable. Certificates of stock, in business corporations, are embraced in the class last mentioned. They are not negotiable in form, they represent no debt and are not securities for money. But the courts of this country, in view of the extensive dealings in certificates of shares in corporate enterprises, and the interest both of the public and of the corporation which issues them, in making them readily transferable and convertible, have given to them some of the elements of negotiability. The owner of shares may transfer his title by delivery of the certificate with a blank power of attorney indorsed thereon signed by the owner of the shares named in the certificate. Such a delivery transfers the legal title to the

shares as between the parties to the transfer, and not a mere equitable right. (*McNeil v. Tenth National Bank*, 46 N. Y. 325.) The transferee in good faith and for value, holds his title free from latent equities between prior parties in the line of transmission. Under the doctrine of implied agency and the application of the principle of estoppel to the situation, the true owner is in many cases precluded from asserting his title."

This Court, in *First National Bank v. Lanier*, 11 Wall. 369 said (p. 377) :

"Stock certificates of all kinds have been constructed in a way to invite the confidence of business men, so that they have become the basis of commercial transactions in all the large cities of the country, and are sold in open market the same as other securities. Although neither in form or character negotiable paper, they approximate to it as nearly as practicable."

In *National Safe Deposit Savings & Trust Company v. Hibbs*, 229 U. S. 391, this Court said (p. 396) :

"It is undeniable that the broker obtained the stock certificates, containing all the indicia of ownership and possible of ready transfer, from one who had possession with the bank's consent, and who brought the certificates to him, apparently clothed with the full ownership thereof by all the tests usually applied by business men to gain knowledge upon the subject before making a purchase of such property. On the other hand, the bank, for a legitimate purpose, with confidence in one of its own employees, intrusted the certificates to him, with every evidence of title and transferability upon them. The bank's trusted agent, in gross breach of his duty, whether with technical criminality or not is unimportant, took such certificates, thus authenticated with evidence

of title, to one who, in the ordinary course of business, sold them to parties who paid full value for them. In such case we think the principles which underlie equitable estoppel place the loss upon him whose misplaced confidence has made the wrong possible."

Thus, under the foregoing authorities, the title which a purchaser obtains from the borrowing broker is not based upon a prior transfer of title to the borrowing broker, but is based upon an estoppel created against the lending broker—an estoppel which bars him from asserting his title. "Title by estoppel" as it has been called, by its very terms indicates that it is not a true title predicated upon an unbroken chain of legal title, but that it is based upon a transfer by a person who has not acquired legal title.

The rule in the foregoing and numerous other similar cases, establishing the quasi-negotiable character of stock certificates endorsed in blank, was made part of the statute law in New York in 1913 by the adoption of the Uniform Stock Transfer Act. Section 166 of the New York Personal Property Law reads:

"Who may deliver a certificate.—The delivery of a certificate to transfer title in accordance with the provisions of section one hundred and sixty-two is effectual, except as provided in section one hundred and sixty-eight, though made by one having no right of possession and having no authority from the owner of the certificate or from the person purporting to transfer the title."

The exceptions contained in Section 168 permit the rescission of a wrongful transfer in certain specific cases, unless "the certificate has been transferred to a purchaser for value in good faith without notice of any facts making the transfer wrongful."

The ability of the borrowing broker to transfer to his purchaser a better title than he himself has, is not peculiar to the

transactions involved in this case. The situation in this respect is no different from that of a broker holding stocks belonging to his customer, either as margin or merely for safekeeping. It has been held repeatedly that, although title to the stocks is in the customer, and not in the broker, whether or not the broker has a lien thereon, the broker may, nevertheless, transfer good title thereto, to an innocent purchaser for value.

Tompkins v. Morton Trust Co., 91 App. Div. (N. Y.) 274; affirmed on opinion of Court below, 181 N. Y., 578;

Matter of Mills, 125 App. Div. (N. Y.) 730; affirmed 193 N. Y. 626.

In the *Mills* case the Court said (125 App. Div. 732) :

"She (the owner) had simply deposited her certificate of stock with Mills Brothers & Co. for safekeeping. She owed them no money and had never had any other dealings with them, and their use of this stock was a larceny. No title to it, as against her, could be acquired by any one except a person who had, in good faith, purchased the stock or loaned money upon it, relying upon the apparent title that she had conferred upon the insolvent firm. The ground upon which the right of a person who in good faith has purchased stock from a bailee, or has acquired the right to hold the stock as security for a loan, is based is stated in *McNeil v. Tenth National Bank* (46 N. Y. 325). It is a right which accrues to the pledgee by estoppel. It in no way depends upon the actual title of the thing pledged or the authority of the party pledging it, * * *"

The rule in the foregoing cases is recognized and approved by this Court. In *Sexton v. Kessler*, 225 U. S. 90, it was contended that where a broker, while insolvent, delivered to

his customer stocks which the broker held as collateral security for advances made by him, he was guilty of making a fraudulent preference. In support of this argument it was contended that the right of the broker to dispose of the stocks was inconsistent with title in the customer. This Court, reviewing the New York cases, pointed out that there was no legal inconsistency in the situation and that it was quite proper to hold that the customer had legal title to the securities and yet that the broker having possession thereof, could transfer title thereto to another. This Court said (p. 97):

"The most obvious objection is that the continued physical power of the New York firm over the securities and its right to withdraw and substitute admittedly reserved are inconsistent with a title or lien of the English house in any form. But the decisions of this Court and of New York agree that there may be title in a stronger case than this. When a broker agrees to carry stock for a customer he may buy stocks to fill several orders in a lump; he may increase his single purchase by stock of the same kind that he wants for himself; *he may pledge the whole block thus purchased for what sum he likes, or deliver it all in satisfaction of later orders*, and he may satisfy the earlier customer with any stock that he has on hand or that he buys when the time for delivery comes." (Italics ours.)

The learned Court below completely misunderstood our argument as to the analogy of the relationship between the lending and borrowing brokers to the relationship between a broker and his customer. Our contention simply is that, in both cases, from the legal standpoint, title to securities in the possession of one may be vested in the other and yet the one holding possession is able to transfer title to a third person. Just as in the case of a broker and his customer, the broker may transfer title to an innocent purchaser

although legal title to the securities so transferred is in the customer, so in the case of the lending of stocks, the borrowing broker may similarly transfer title to his purchaser even though legal title thereto was at the time of the transfer in the lending broker. The analogy, we insist, is complete. There is nothing in the latter case which causes any greater legal difficulty than the former. Both depend upon the peculiar characteristics of stock certificates endorsed in blank, viz., their quasi-negotiable character.

The failure of the learned Court of Claims to recognize the analogy is indicated by its opinion in which (pp. 16-17) it endeavored to explain the differences between the lending of stock and the purchase of stock by a broker on margin. Concededly there are differences in the manner of executing a long purchase for a customer, from the operations necessary in connection with a short sale. We have never claimed that the mechanism of one is similar to the mechanism of the other. The lengthy discussion by the Court of such differences is wholly apart from the point and indicates completely the misconception of the Court as to the real analogy between the two transactions. That analogy is purely a legal analogy and relates merely to the peculiar characteristic of both transactions, to wit, that in both transactions the holder of stocks endorsed in blank is able to transfer title to an innocent purchaser, although the holder himself may not be vested with such title.

Our contention that the lending of stock does not involve a transfer of legal title, makes it proper to ask us—what, legally, is a loan of stock? In answer to that question we state that a loan of stock has all the attributes and characteristics of a pledge of stock, and is in every material respect, from the legal point of view, identical with an ordinary pledge of stock.

Our conclusion is justified not only by an analysis of the transaction from the lawyer's point of view, but also from that of the stockbrokers themselves and that of the eco-

nomists who have made a study of the ramifications of a stock broker's business. That phase of the case is discussed in our fourth point, in which we point out that the lending of stock comes clearly within the first proviso of the 1917 and 1918 Acts, which expressly exempts from tax the deposit of stock certificates as collateral security for money loaned thereon.

For the present, however, we are concerned rather with the erroneous assumption of the learned Court below that the lending of stock involves a transfer of title. This calls for a study of the purely legal aspects of the transaction. If it is a pledge, it cannot, of course, involve a transfer of title.

Our position that it is a pledge is fortified by a survey of the various legal concepts which may appear to be created where physical transfer of stocks occurs. Such survey leads first of all to the conclusion that the lending of stock is in no sense similar to any of the transfers which involve a change of legal title, and secondly, to the conclusion that it is, in legal effect, a pledge.

(1) *Sale.* A most obvious form of transfer is that incident to the making of a sale of stock. Such transfers were taxable by reason of the express provisions of the Acts of 1917 and 1918. What are the characteristics of a sale? Do any of those characteristics exist in the case of the transfer here under discussion? Quite obviously they do not.

We correctly define a sale, we believe, when we state that it is a transfer of the property or title in an article or thing, for a price paid by the purchaser.

There are collected in 35 Cyc. at page 25, a large number of definitions of a sale, all of which indicate that these two elements to which we have referred, when present, cause a transaction to be a sale, i. e., a transfer of title or property and the payment in return of a price. A sale has been defined by this Court as "a transfer of property for a fixed price in money or its equivalent."

Iowa v. McFarland, 110 U. S. 471.

Can it be said that these two elements, to wit: a transfer of property or title and the payment of a price, or either of them, are present in the case of the transfer of a certificate of stock by one broker to another for the purposes indicated in this claim? No price is paid by the borrowing broker to the lending broker and the transaction, therefore, cannot be denominated a sale, whatever else it may be.

Is the other element which would be necessary to make the transaction a sale present, viz: the transfer of property or title to the certificate of stock? We need not discuss this aspect of the case at the present time because clearly there is no sale because no price is paid. We have, however, already indicated that the element of transfer of title is wholly lacking.

Nor can we conceive of any logical explanation which could harmonize the *hypothesis* that the transaction is a sale with the *fact* that the lending broker pays interest upon the money which he receives at the time the stock is delivered and the fact that he continues to receive the benefit of any dividends and other increase of the stock, and conversely, continues to be liable for any assessments or other charges against the stock. Nor can such theory be harmonized with the fact that the lending broker gains the benefit of any increase in the market value and likewise bears any loss which may result from a decline in such market value.

(2) *Gift*. A gift *inter vivos* has been defined as "an immediate, voluntary and gratuitous transfer of personal property by one to another."

Chambers v. McCreery, 98 Fed. 783 (affirmed 106 Fed. 364).

The following definition of a gift is found in 28 *Corpus Juris* 620:

"A gift has been defined as a voluntary transfer of property by one to another, without any consideration or compensation therefor."

Clearly, a loan of stock under the circumstances disclosed is not a gift.

(3) *Trust*. Various definitions have been given of the legal idea of a trust. Possibly the simplest definition is that it is a holding of property subject to the duty of employing it, or its proceeds, according to the directions given by the person from whom it was derived.

39 Cyc. 17.

There is nothing in the transactions involved in this claim which partakes in any manner of the nature of a trust. We merely refer to this form of transfer because it is one of the various conceivable forms of transfer. But it can hardly be said that the borrowing broker holds the stock in trust for the lending broker or that there is anything else in the transaction which indicates a trust relationship.

(4) *Bailment*. A bailment is defined as a "delivery of goods for some purpose upon a contract, express or implied, that after the purpose has been fulfilled they should be re-delivered to the bailor or otherwise dealt with according to his directions or kept until he reclaims them."

Wood Mowing & Reaping Machine Company v. Vanstory, 171 Fed. at page 378. 6 Corpus Juris, 1084.

A bailment is defined in Bouvier's Law Dictionary as "a delivery of something of a personal nature by one party to another, to be held according to the purpose or object of the delivery and to be returned or delivered over when that purpose is accomplished."

These definitions indicate a close similarity to the transactions involved in this claim. The borrowing of stock, from the facts disclosed, is nearer to a bailment than any of the other forms of transfer which we have yet enumerated. Bailments, of course, are of various kinds and a mere naked bailment lacks many of the characteristics which are disclosed in the transactions in question. The form of bailment which is known as a pledge, however, contains all those elements which exist in the case of a loan of stock as described in this claim.

(5) *Pledge*. A pledge is defined as "a transfer of personal property as security for a debt or other obligation."

31 Cyc. 785.

Three elements are said to be necessary to constitute a contract of pledge, viz: (1) The possession of the pledged property must pass from the pledgor to the pledgee or to some one for him; (2) The legal title to the pledged property must remain in the pledgor; (3) The pledgee must have a lien on the property for the payment of a debt or performance of an obligation due him by the pledgor or some other person.

31 Cyc. 787.

An analysis of the methods by which stocks are "loaned" shows that all those various elements are present which are necessary to constitute the transaction a pledge as distinguished from the various other forms of transfer.

One possible objection may be made by counsel for the Government to our contention that the lending of stock constitutes a pledge thereof, viz., that a pledgee has no right to part with possession of the pledged property.

We have already indicated that, apart from the *right* of a pledgee of stocks to part with their possession, it is legally possible for such a pledgee to transfer good title thereto to

a purchaser for value. The answer to counsel's objection that the ability to transfer title to an innocent purchaser does not give the pledgee the right to do so, is found in a series of cases with which this Court is familiar and which add another peculiar characteristic to pledges of stock certificates; for it is firmly settled that a pledgee of stock is not required to retain in his possession the identical certificates of stock pledged with him. Such certificates are interchangeable, and the rights of the pledgor are not infringed by the transfer by the pledgee of the certificates of stock pledged. The status of the pledge is maintained so long as the pledgee has in his possession *or under his control*, a similar amount of similar stock. It is by virtue of this rule, peculiar to pledges of corporate stocks and bonds, that the borrowing broker not only is legally able to transfer good title to an innocent purchaser, but is enabled to do so without violating any of the rights of the lending broker and without being guilty of conversion.

The rule to which we have referred has been repeatedly sanctioned by the highest authorities.

In *Richardson v. Shaw*, 209 U. S. 365, this Court carefully considered the objection made that the right to sell or pledge the particular certificate of stock held by a broker for the account of a customer militated against a holding that the transaction was a pledge. The Court said, pages 378 and 379:

"A certificate of the same number of shares, although printed upon different paper and bearing a different number, represents precisely the same kind and value of property as does another certificate for a like number of shares of stock in the same corporation. It is a misconception of the nature of the certificate to say that a return of a different certificate or the right to substitute one certificate for another is a material change in the property right held by the broker for the customer. *Horton v. Morgan*, 19 N. Y. 170; *Taussig v. Hart*, 58

N. Y. 425; *Skiff v. Stoddard*, 63 Connecticut, 198, 218. As was said by the Court of Appeals of New York in *Caswell v. Putnam*, 120 N. Y. 153, 157, 'one share of stock is not different in kind or value from every other share of the same issue and company. They are unlike distinct articles of personal property which differ in kind and value, such as a horse, wagon or harness. The stock has no earmark which distinguishes one share from another, so as to give it any additional value or importance; like grain of a uniform quality, one bushel is of the same kind and value as another.'

Nor is the right to repledge inconsistent with ownership of the stock in the customer. *Skiff v. Stoddard*, 63 Connecticut 216, 219; *Ogden v. Lathrop*, 65 N. Y. 158. It was obtained in the present case by a contract specifically made and did not affect the right of the customer, upon settlement of the accounts, to require of the broker the redemption of the shares and their return in kind.

It is true that the right to sell, for the broker's protection, which was not exercised in this case, presents more difficulty, and is one of the incongruities in the recognition of ownership in the customer; nevertheless it does not change the essential relations of the parties, and certainly does not convert the broker into what he never intended to be and for which he assumes no risk, and takes no responsibility in the purchase and carrying of shares of stock."

The Court quoted with approval the following extract from *Skiff v. Stoddard*, 63 Conn. 216:

"So long as the interpretation of the contract preserves as its distinctive feature the principal proposition that the customer purchases merely the right to have delivery to him in the future, at his option, of stocks or securities at the price of the day of the agreement, and its corollary that the customer derives no right, title

or interest in the stocks or securities until final performance, the difficulties in the way of harmonizing the situation are bound to exist. The fundamental difficulty grows out of the necessary attempt in some way to transform the customer, who enjoys all the incidents and assumes all the risks of ownership, into a person who in fact has no right, title or interest, and to create out of the broker, who enjoys none of the incidents of ownership, and assumes not a particle of its responsibility, a person clothed with a full title and an absolute ownership."

We might paraphrase the statement of the Connecticut Court and say with equal propriety concerning the contention of the Government that the fundamental difficulty with that contention grows out of the necessary attempt in some way to transform the lending broker, who enjoys all the incidents and assumes all the risks of ownership, into a person who, in fact, has no right, title or interest, and to create out of the borrowing broker, who enjoys none of the incidents of ownership and assumes not a particle of its responsibility, a person clothed with a full title and an absolute ownership.

There are numerous other cases which hold squarely that by reason of the peculiar nature of a certificate of stock, the fact that the borrower of the stock may dispose of it and pass good title thereto is in no way repugnant to the transaction being a pledge of the stock.

This rule is founded upon sound common sense. The reasoning which stands behind it is clearly set forth in the case of *Atkins v. Gamble*, 42 Cal. 86, 100, wherein the Court said:

"The general rule is, as we have stated, that the owner of personal property which has been wrongfully converted, is entitled to recover his specific property or its value, and cannot be compelled to accept other property of the same kind and of equal value, in lieu of that

which was converted. The reason of the rule is obvious. The owner may have special reasons for desiring to retain that specific chattel; and there may be reasons why he attached a peculiar value to it beyond the value of other chattels of a precisely similar kind. If his desire in this respect be the result of mere caprice, he is entitled to be gratified in the exercise of it. Visible, tangible chattels may have secret defects which no vigilance could detect. If two visible objects be apparently precisely similar, one may have infirmities not discoverable on inspection, which would impair or destroy its value. Hence the owner of such chattel cannot be compelled to accept in lieu of it another which appears to be precisely similar, and of equal value. He cannot be required to take the risk of secret defects in the substituted article. Other considerations, also, affect the general rule. If a favorite horse, a pet dog, or a family picture be converted by a wrongdoer, he could not escape responsibility by offering another horse, dog or picture, even of greater value. But we think the reason of the rule ceases when applied to stocks. It is impossible that any sane person should have centered his affections upon a particular stock certificate, or that any violence could be done to his feelings by requiring him to accept another certificate of precisely similar character, in lieu of it. His own certificate was only the evidence that he owned an undivided interest in the capital and business of the corporation. Another certificate of the same kind, for the same amount of stock, would entitle him to precisely the same rights as the former certificate. Each would be a precise equivalent of the other, and it is certain he could suffer no pecuniary loss by the transaction; whilst the nature of the property, or rather of his interest in it forbids the idea, that it could be the object of personal attachment, or have a peculiar value in his estimation as contra-distinguished from any other equal number of shares in the same company."

The law in New York, where the transactions involved in this claim took place, is quite in accord with the principles above set forth; in fact, it is in this State that the question has been most frequently considered and determined.

In *Douglas v. Carpenter*, 17 App. Div. 329, the Court, discussing the obligations of a broker holding stock as pledgee, said (p. 331) :

“The defendant (the customer) had the ownership of the securities, but not the right of possession. His interest in the property consisted in his right of redemption. By payment or tender of the indebtedness the lien of the plaintiffs would have been discharged, and the defendant would have become entitled to the immediate restoration of his property. The plaintiffs might take title to the securities in their own name, and were not bound to retain or deliver the identical securities purchased for the defendant. Their duty was to keep on hand, or under their control, either the securities of the defendant or a like kind and amount of securities, and to have them in such situation that the defendant, by paying the amount due by him thereon, could, at any time, obtain them. This was what the plaintiffs agreed to do, and so long as they did this, the fact that they used the securities while in their possession, awaiting redemption by the defendant, would not amount to a conversion thereof. These principles are well settled and are recognized by both parties.”

In *Caswell v. Putnam*, 120 N. Y. 153, the Court said (p. 157) :

“One share of stock is not different in kind or value from every other share of the same issue and company. They are unlike distinguished articles of personal property which differ in kind and value, such as a horse, wagon or harness. The stock has no ear-mark which

distinguishes one share from another, so as to give it any additional value or importance; like grain of a uniform quality, one bushel is of the same kind and value as another. This doctrine appears to be well sustained by authority."

By the system of mark-ups and mark-downs which has been described in the stipulation of facts, the lending broker is fully protected with respect to the borrowing broker's performance, for the lending broker at all times holds an amount of money equivalent to the market value of the securities. Because of this system, which protects each broker from loss by reason of default of the other, litigation is practically avoided and so the decisions are silent as to the liabilities of the respective parties in the event of a default on either part. But an analysis of the situation which would arise in the event of such default is helpful.

Suppose, for example, the lending broker, as he has the right to do at any time, were to tender the appropriate amount of money and demand of the borrowing broker the return of the stock loaned to him. What remedy would the former have in the event of a refusal on the part of the borrowing broker to deliver back the stock? The obligation in such case is identical with that of a broker to his customer when the customer tenders the amount of his indebtedness and demands his securities. The obvious remedy is an *action in conversion*. We know of no other. As a practical matter, the lending broker might, of course, use the money held by him to purchase an equivalent amount of similar stock, and thus make good the borrowing broker's obligation. But such remedy would be an extra-legal remedy. While one holding stock as security for a debt owing to him may extinguish the owner's right to that stock by a sale of it after a proper notice and demand, we know of no way in which the reverse may be done, i. e., for the debtor to extinguish the debt by reason of the default of the creditor to deliver back the security held by him. In other words,

so far as we can discover, the lending broker's remedy legally can be no other than an action for conversion or, what amounts to the same thing, a suit upon contract waiving the tort. Can such an action for conversion be harmonized with any theory other than the continued ownership of the stock by the lending broker? We respectfully urge that it cannot.

Suppose the situation were reversed, and that the borrowing broker upon direction from his customer covered the short sale and made a tender of the stock to the lending broker and demanded the return of the money deposited with the latter. What would the remedy be in the event of a refusal by the lending broker? If the relationship between the two brokers were merely contractual and no property rights in the stock were involved, the remedy would be merely an action for damages for breach of contract, and the measure of damages would undoubtedly be the difference between the value of the stock held by the borrowing broker and the amount of money in the hands of the lending broker. But could any such theory properly be evolved which would be consistent with the lending broker's continued right to dividends and other increase of the stock, or the borrowing broker's right to interest on the money deposited? It must be apparent that the borrowing broker, upon the lending broker's default, is entitled to bring his action against the lending broker as upon a *debt*. It would be difficult, in fact impossible, to harmonize the facts indicated by the stipulation in this claim with any merely contractual relationship as distinguished from a property right on the part of the lending broker in the stock which is the subject matter of the loan. If the lending broker retains a property interest in that stock, it must conversely be true that the borrowing broker has a claim against the lending broker, not merely for the difference between the value of the stock and the amount of money, but for the full amount of the money deposited with the lending broker.

The obvious and proper remedies of the parties reflect the rights of the parties and indicate that such rights are predi-

cated upon a relationship based upon a continued ownership of the stock on the part of the lending broker; in other words, the relation of debtor and creditor with respect to the moneys advanced by one broker to the other and of pledgor and pledgee with respect to the stock delivered.

Another practical consideration militates strongly against the holding that the lender of stock transfers title to the borrowing broker. It may be assumed that the lending broker turns over to the borrowing broker certificates of stock which are long in some customer's account and which he holds as margin. As we have indicated in our preliminary statement, the purpose of the lending broker is in each case to procure the use of the money deposited with him by the borrowing broker, in the same manner as he might procure the use of money by replying the stocks with a bank as security for a loan thereon. The latter the broker may lawfully do; for the customer in every case, either by express agreement or by implication in law, authorizes the replying by the broker, of the securities which are long in his account. Such authority, however, has never been held to go to the extent of authorizing a broker to part with title thereto.

If the conclusion of the learned Court below is correct, and if the lending of stocks by one broker to another constitutes a transfer of title or ownership, the entire practice must be condemned as based upon an illegal course of conduct, and in fact, upon an out-and-out conversion by the lending broker, of his customer's stock. It is impossible to believe that a practice which has so long prevailed among brokers, and which has had the sanction of the courts (*Matter of Mills*, 139 App. Div. (N. Y.) 55) and of the Executive Department of the State (Report of Gov. Hughes' Committee on Stock Speculation, June 7, 1909) can be based on an illegal, and in fact, criminal act.

At the risk of needless repetition, we again point out that the agreement between the lending and borrowing brokers

provides for the retention of all the rights of ownership in the lending broker. That agreement, under which title is retained in the lending broker, does not violate the rights of the latter's customers. The holding of the learned Court of Claims, however, converts such lawful agreement into an illegal and criminal act. We earnestly and respectfully urge that such conclusion is wholly unjustified.

C.

The opinion of the Attorney General, upon which Treasury Decision 2685 was based, was rendered without a complete understanding of the facts and was based upon an erroneous assumption of the facts and a misapprehension of the law applicable to the transactions in question.

The opinion of the Attorney General, dated March 23, 1918, (31 Op. Atty. Gen., 255), to which Treasury Decision 2685 refers and upon which the Government relies, is based upon a complete misunderstanding of the facts as well as an erroneous application of the law.

We respectfully insist that the learned Attorney General fell into error in the assumption that the delivery of stock by the lending to the borrowing broker constitutes a transfer of title.

The learned Attorney General asserted that "there can certainly be no doubt that there is a transfer of the legal title from the lender to the borrower and later from the borrower to the lender under the circumstances stated." In support of his opinion he cites:

- (1) The example of a mutuum in Roman Law;
- (2) Cases relating to fungible goods deposited in a warehouse;
- (3) Cases relating to deposits of money in banks;
and
- (4) The peculiar characteristics of shares of stock.

We will refer to these points seriatim.

(1) A mutuum is, so far as we can find, unknown to the common law. It is a form of bailment recognized in the Roman Law, and apparently only occasionally encountered in the Civil Law. It seems to be "a loan of property for consumption, to be returned in kind and without interest or compensation for the use."

Payne v. Gardiner, 29 N. Y. 146, 167.

The case last cited is, we believe, the only case in which there is any extended discussion of the term "mutuum" in the American reports. That case involved the deposit of money. So far as we can discover, no Court has ever held that the deposit of stock as security for a loan, or the lending of stock under the circumstances disclosed in the present claim, can properly be termed a mutuum.

(2) A deposit of fungible goods in a warehouse is to a certain extent analogous to the loan or pledge of certificates of stock, but the analogy, instead of supporting the Attorney General's contention that title passes to the pledgee or borrowing broker, weakens that contention; for it is fundamental that *title to the fungible goods does not pass to the warehouseman*. It is true that the warehouseman may, without being guilty of conversion, hand my grain over to another, so long as he has in his possession a similar quantity of similar grain for my account. That is because one bushel of a particular kind and grade of grain is the same as any other similar quantity of the same kind and grade, just as one certificate of stock in a corporation is the same as any other certificate for the same amount of stock in the same corporation. Cases are numerous which hold that title does not pass to the warehouseman and that the various depositors of the grain are owners of the commingled mass as tenants in common, each of his respective quantity.

The rule, supported by the citation of a large number of American cases illustrating it, is stated in 6 *Corpus Juris* 1097, as follows:

“Where grain is deposited in an elevator or in a warehouse on an understanding, express or implied that the warehouseman may mix it with other grain of like quality, and shall return to the depositor the amount of his deposit out of the mass which is to be kept good to that extent, the various owners of the grain are tenants in common, and the transaction is a bailment.”

The analogy, therefore, of deposits of fungible goods, instead of being helpful to the Government's contention, destroys the very foundation upon which the opinion of the Attorney General is based.

(3) It is true that the relation between a bank and its general depositors is that of debtor and creditor. But obviously there is nothing in common between a loan of stock and a mere deposit of money in a bank. It will not be contended that there can be such a thing as a debtor and creditor relationship as to certificates of stock. The word debt of itself can mean nothing except as applied to money.

The analogy, as we shall indicate in our next point, is rather to the deposit of stock with a bank as collateral security for the loan of money. In such case it has never been held, so far as we know, that title passes to the bank.

(4) The fourth ground for the learned Attorney General's conclusion that title to the borrowed securities passes to the borrowing broker is based upon the peculiar characteristics of certificates of stock. But we respectfully urge that the learned Attorney General has misconceived the holding of this Court and other Courts as to the characteristics of pledges and bailments of stock. The right of the pledgor

or bailor is not, as the learned Attorney General suggests, a mere equitable right, but it is as well established a legal right as any other property right with which we are acquainted. In fact, the very excerpt from the opinion of the Supreme Court in *Gorman v. Littlefield*, 229 U. S. 19, quoted by the Attorney General, indicates that *the pledgor or owner of stock is not deprived of his property right*, in spite of the broker's privilege of substituting other similar certificates. The quotation reads in part:

"That the return of a different certificate or the substitution of one certificate for another *made no material change in the property right of the customer.*"

An action at law for conversion could never be brought against a broker by his customer if the customer did not retain legal title to the pledged securities, whether the identical ones delivered by him or others; yet, such an action is the common and recognized remedy available to the customer in the event of the failure of the broker to return the pledged securities or similar securities upon proper tender and demand.

Richardson v. Shaw, 209 U. S. 365;

Markham v. Jaudon, 41 N. Y. 235;

Strickland v. Magoun, 119 App. Div. (N. Y.) 113;
(affd. 190 N. Y. 545.)

Mayer v. Monzo, 151 App. Div. 866.

In the *Strickland* case, *supra*, the Court, speaking of the rights of a margin customer, said (p. 116) :

"When a broker purchases for customers stock upon a margin, the legal title to the stock vests in the customer. The relation of debtor and creditor existing between the customer and broker as to the unpaid balance

of the purchase money, and the stock being in the possession of the broker, it is deemed pledged to him as security for such unpaid balance. The relation of pledgor and pledgee, therefore, arises with this qualification to the usual rule applicable to such relation. It is not necessary that the broker should retain in his possession the identical stock purchased on his customer's order. It is sufficient if he has in his possession, or under his control, an amount of the stock in question equal to that purchased, which he can deliver to the customer when the account is closed. (*Caswell v. Putnam*, 120 N. Y. 153; *Douglas v. Carpenter*, 17 App. Div. 329.) *An unauthorized sale or an unauthorized loan of the stock is a conversion thereof.*" (Italics ours.)

In *Mayer v. Monzo*, *supra*, the Court said (p. 868) :

"The broker's whole duty to his customer under such circumstances is either to have on hand or under his control the stocks which he is carrying for his customer, but he is not required to do both, that is to have the amount of stocks under control and also an equal amount on hand. *The customer's right to receive his securities accrues under such circumstances only when he tenders the amount he still owes and demands his stock. The refusal of such a demand constitutes the conversion.*" (Italics ours.)

It will, however, serve no useful purpose to discuss in detail this peculiar legal rule, but beyond question it does exist, and it does not operate to deprive the pledgor or bailor of legal title, even though it does operate to permit the broker who holds securities belonging to another to pass good title thereto to a third person. As between the parties primarily concerned, there is clearly no passing of title. We have already pointed out that the borrowing broker might pass good title, even without regard to the rule in the *Rich-*

ardson and *Gorman* and other cases, by virtue of the quasi-negotiable character of certificates of stock assigned in blank.

The cases referring to loans of stock are merely corollaries to the cases above referred to, and hold simply that title to the borrowed stock may be transferred by the borrowing broker to a third person, just as the same thing can be done in the case of any ordinary pledge of stock.

The case of *Dykers v. Allen*, 7 Hill 497, cited by the Attorney General, is an old case, in which the Court declined to recognize the custom which gave a pledgee of stock the right to dispose of the particular certificate pledged. The holding in that case has long since been rejected, for the decisions have for years sanctioned this custom and it now has the force of law.

The case of *Barclay v. Culver*, 30 Hun 1, also cited by the Attorney General, holds merely that in the case of a loan of stock, the identical certificate need not be returned, and, accordingly, that the borrowing broker may transfer good title thereto to another. It is merely a decision touching upon the peculiar characteristic of pledges or bailments of shares of stock already discussed.

Fosdick v. Greene, 27 Ohio St. 484, likewise holds merely that the borrower of stock need not return the identical certificate and that he can transfer good title thereto to a third person.

It is, therefore, apparent that the opinion of the learned Attorney General was not well considered. It is quite likely that had the *modus operandi* of a short sale been properly presented to him, the misconception of the facts upon which the opinion was based would not have existed. As to the law, we respectfully submit that the cases cited by the Attorney General do not call for a conclusion contrary to that for which we contend.

It is clear from the foregoing discussion that the lending of stock and the return of borrowed stock cannot properly be held to be taxable under the enacting clauses of the 1917 and 1918 acts. Those clauses, by their language, purport to impose a tax upon sales and similar transfers of ownership or title. The word "deliveries" cannot reasonably be extended to cover every physical transfer, and must be limited to deliveries involved in transactions similar to those enumerated. The lending of stock as practised by brokers, when analyzed, is found to be wholly different from a sale or similar transaction. It has all the characteristics of a pledge. It is only by holding it to be a pledge that the legal rights of all the parties are preserved. Any other holding does violence to the purpose and the intent of the parties and operates to make the entire transaction illegal. The Attorney General in his opinion, upon which Treasury Decision 2685 was based, indicated a complete misapprehension not only of the facts, but also of the law applicable to the transactions in question.

POINT IV.

THE LENDING OF STOCK IS EQUIVALENT TO THE DEPOSIT OF STOCK AS COLLATERAL SECURITY FOR MONEY LOANED THEREON AND IS, THEREFORE, EXEMPT FROM TAX UNDER THE FIRST PROVISIO OF PARAGRAPH IV OF SCHEDULE A.

Paragraph 4 of Schedule A of the 1917 Act, after specifying the transfers which are taxable, reads:

"Provided, That it is not intended by this title to impose a tax upon an agreement evidencing a deposit of stock certificates as collateral security for money loaned thereon, which stock certificates are not actually sold, nor upon such stock certificates so deposited."

The proviso in the 1918 Act reads similarly:

"Provided, That it is not intended by this title to impose a tax upon an agreement evidencing a deposit of certificates as collateral security for money loaned thereon, which certificates are not actually sold, nor upon the delivery or transfer for such purpose of certificates so deposited."

Irrespective of the language of the enacting clause, which has been discussed in the preceding point, it is our contention that the borrowing of stock and the subsequent return of such borrowed stock, under the circumstances disclosed in this claim, are expressly declared to be non-taxable by the provisos above quoted.

For it is a necessary concomitant to the borrowing of stock that there be a lending of money for the repayment of which the stock stands as security.

As we have indicated in our preliminary statement, the practice of lending and borrowing stocks has become so firmly established that any person who desires to sell short any of the securities dealt in on the New York Stock Exchange can give an order to his broker to sell, with full assurance that the stock can generally be borrowed to make delivery. Such a custom cannot be based upon a mere exchange of courtesies between brokers. As we have further indicated, the lending broker obtains a real advantage in the transaction, in that he thereby procures a loan of money of an amount equivalent to the value of the securities loaned, and that this loan has all the characteristics of a call loan obtained from a bank with advantages over the bank loan both as to the amount of money advanced against the securities delivered and as to the interest rate.

In fact has not the lending broker the greater advantage in the transaction? What does the borrowing broker gain? Nothing but his nominal commissions for executing the order to sell and the assurance that ultimately there will be a

similar nominal commission when the order to purchase is given. For these two transactions he receives the same compensation as a broker would receive if he were to execute an order to purchase and thereafter execute a similar order to sell, both of which are done without borrowing the stock. In making a short sale, the broker must necessarily go to the trouble of borrowing the stock and of keeping it borrowed and of subsequently returning the stock, without any additional compensation, for he receives no commission on the borrowing of the stock, nor on any of the subsequent borrowings or returns of stock which may be necessary to keep the short sale alive.

It is the lending broker who gains the real advantage, for he thereby procures the loan of money which is so essential to him in the conduct of his business. From the point of view of the lender of the stock, therefore, the incentive to lend stock is solely the opportunity which is offered to borrow money.

As the broker who is instructed to sell short by his customer, can safely undertake to execute the order with full assurance that the stock will be made available by borrowing, so for the same reason the broker with stock to lend may be assured of the opportunity to avail himself of his need to raise money by the lending of his stock. The volume of dealing by brokers on the Stock Exchange makes for stability.

An historic example of the truth of this statement is given in the book entitled "The Stock Exchange from Within," by Mr. William C. Van Antwerp. He writes (p. 87):

"Many years ago there was a law on the French Statute books, subsequently repealed, prohibiting short sales. M. Boscary de Villeplaine, a deputy chairman of the association of stockbrokers, was conversing with Napoleon regarding a pending discussion in the Council of State looking to the repeal of the law. 'Your Majesty,' said de Villeplaine, 'when my water carrier is at the door,

would he be guilty of selling property he did not own if he sold me two casks of water instead of only one, which he has?' 'Certainly not,' replied Napoleon, 'because he is always sure of finding in the river what he lacks.' 'Well, your Majesty, there is on the Bourse a river of Rentes'."

The operation of the New York Stock Exchange has been the subject of considerable literature on the part of economists and investigators. It is significant that, wholly apart from the aspect of the tax laws under which this claim arises, the writers who have discussed the question of lending of stocks are unanimous in declaring that the loan of stocks in connection with short sales is nothing more nor less than the borrowing of money on the part of the broker lending the stocks.

We refer to the discussion by Mr. Meeker of the situation set forth in the agreed statement of facts and to the findings of the Court below. At page 82 of Mr. Meeker's volume he writes:

"Function of the 'Loan Crowd.'

To avoid just this dilemma which brokerage houses would otherwise experience in making deliveries of stock which had been sold short by their customers, a system of borrowing and loaning stocks has developed on the floor of the Stock Exchange which is a counterpart of the system also developed there for borrowing the 'call money' with which the margin purchasers of brokers' customers are regularly financed. Every morning about 9:45 A. M. the 'loan crowd' assembles at a certain post, and within it the loaning and borrowing of stocks go on intermittently till 1:30 P. M.; it then ceases entirely until between 3 and 3:30 P. M., when most of the day's loans are made.

This loan crowd is composed of Exchange members

who wish to borrow or loan stocks. White and Company's Board member—i. e., the particular partner in the firm who is a member of the Exchange and who handles its business on the floor—therefore seeks out Green, a broker with 100 shares of American Locomotive to lend. *To obtain the loan of Green's stock, White and Company usually have to agree to lend Green a sum of money equal to its market value.* If, for example, American Locomotive closed that day at 100, Green will obtain a loan of \$10,000 in return for the loan of the stock which he makes to White and Company. It is understood between such lenders and borrowers of stock that the amount of this money loan must be kept at a figure equivalent to the market value of the stock in question. Should American Locomotive rise from 100 to 105, White & Company would have to loan Green an additional \$500 upon it; while if the stock should decline from 100 to 95, Green would have to return to White and Company \$500 of the original loan of \$10,000.

Thus Green borrows White and Company's money and White and Company borrows Green's stock. But the money still belongs to White and Company, and the stock to Green. For this reason Green must normally pay interest on the money borrowed from White and Company. On the other hand, White and Company must pay to Green such dividends as may be declared upon the stock borrowed from him. Of course, Thompson, as a principal, must in turn repay these dividends to his agents, White and Company. This necessity of the short seller to pay for dividends in this way, which often puzzles inexperienced traders and investors, has been likened to the case of farmer X who loans his cow to farmer Y. If in the course of this loan the cow has a calf, it naturally belongs to X, the owner of the cow, and not to Y, who is simply the borrower of the cow." (Italics ours.)

In the work of Frederick S. Todman, entitled "Wall Street Accounting" (1921), the lending of stock is shown to be one of the routine methods of borrowing money. The author writes, at page 46:

"To illustrate the loan of stock, suppose a broker purchases 1,000 shares of Steel common on margin for a customer. As the customer has deposited only a 10-point margin, or such other amount as the broker may have required—or, in the case of a credit customer, has put up nothing at all—the responsibility of financing the transaction falls mainly upon the broker. Under the rules of the Stock Exchange, the purchased stock must be delivered and paid for the next day, unless other than the regular delivery is stipulated. In the case of Steel common, which is a clearing house stock, delivery is made by the broker designated by the clearing association. If it is not a clearing house stock, delivery is made by the broker from whom it is has been purchased. In either case the purchasing broker must be prepared to give his check to the delivering broker on the day of delivery or the next business day after the making of the contract, with the exception of Saturday, which is not a delivery day.

If the broker has funds available, the question of paying for his stock is merely a matter of drawing his check. If funds are scarce, he has two courses open to him: (1) he can borrow the money from the bank on collateral, or (2) *he can borrow the money on the Street from one in need of the shares.*

It is usually more expedient to borrow money by lending stocks to the Street than it is to borrow it of a bank on a collateral loan. In the first case, full market value is received; while in the latter only from 60% to 80% of the value is obtained. *Stocks are also loaned to the Street more easily and conveniently than money is borrowed from a bank.*" (Italics ours.)

Further, at page 49, Mr. Todman says:

"To repeat, lending stocks on the street, which is equivalent to borrowing money on collateral, is a very advantageous arrangement for the broker who wishes money, inasmuch as he then borrows to the full market value, whereas, if he pledges the securities as collateral at his bank, he receives but from 60% to 80% of their value. Furthermore, the rate of interest is usually lower than the rate charged by banks on demand loans." (Italics ours.)

It is, therefore, apparent that the lending of stocks is in no wise different from the borrowing of money upon the deposit of securities as collateral. Just as the volume of dealing on the Stock Exchange makes it possible for a person to sell short with assurance that similar stock can readily be borrowed in exchange for the loan or advance of an equivalent amount of money, so the broker with securities on hand who finds it necessary to borrow money to finance his customers' accounts is assured of a ready means of borrowing money by lending these securities. It is a reciprocal arrangement. To look only to the borrowing broker's side of the transaction and to ignore the point of view of the lending broker results in a perverted and distorted view of the transaction. The argument of counsel for the Government must necessarily be based upon such viewpoint alone.

The learned Court below declined to give consideration to the contention that the lending of stocks is similar in its nature to a bank loan upon the deposit of securities as collateral. A bank loan, the Court said (R. 19), "is wholly foreign to the modus operandi of speculation in stocks and bears no relation to it."

From what we have already said, if we are at all correct in our statements, there is nothing of a speculative nature in the transaction as it takes place between the lending and

borrowing brokers. There is no justification for the statement that a bank loan is wholly foreign to the modus operandi of stock speculation. For it is notorious that it is only because of the ability of stockbrokers to finance margin transactions by means of bank loans and the like, that speculation in stocks is made possible. No broker is financially able to handle without such aid the margin transactions of his customers. Only a relatively small part of such financing is done by the expedient of lending stocks, but in so far as brokers do lend stocks to other brokers, their motives are no more speculative, or in aid of speculative transactions of their customers, than when they raise money in a similar way by taking the same securities to a bank and procuring a loan of money thereon to finance their customers' marginal accounts.

The error of the Court below, is particularly emphasized by its misconception of the interest phase of the agreement between the lending and borrowing brokers.

The Court below, in its opinion, states:

"M (the broker lending the stock), if the agreement so provides, may be required to pay interest on the deposited funds at a rate agreed upon."

This is a misconception of the transaction. The misconception is further exemplified by the two following sentences:

"M may, if he chooses, decline to pay any interest whatsoever and instead exact a premium for the loan of the stock. The question of loaning and the terms of the loan rest with M."

Statements similar to the foregoing appear throughout the opinion, and the Court quite obviously considered them as vitally important to its decision. These statements, however, are entirely inaccurate and are not justified by anything contained in the agreed statement of facts. They are

not only incorrect in fact and unsupported by the facts, but they are even inconsistent with the agreed statement of facts. The interest rate is no more within the control of the lender of the stock than the interest rate which a bank receives or pays is within the control of the bank. The law of supply and demand operates here as in any other ordinary business transaction. Just as in the case of a purchase and sale of commodities the seller may decline to sell except at a stated price, to that extent the seller may be said to control the price. The buyer is of course under no compulsion to buy at that price, and if he can procure the same commodity elsewhere at a lower price the first seller will not consummate his sale.

So likewise in the case of the borrowing or lending of stock. Broker Y (to use the designation of the learned Court below) in his transaction with broker M, is endeavoring to procure the loan of one hundred shares of a designated stock. Broker M in turn is not actuated by altruistic motives in lending his stock to Y. His interest in the transaction is to procure the use of the money which Y will deposit with him simultaneously with the delivery of the stock. M can obtain money by pledging the stock with a bank, in which case he would be required to pay a given rate of interest which is known as the call money rate. That rate of interest fluctuates in accordance with the supply of and demand for money. Broker M would therefore ordinarily not be willing to pay more than the prevailing call money rate. That may be said to control, to a large extent, the maximum rate which broker M can be called upon to pay for the use of broker Y's money. The learned Court below, however, bases its decision on the theory that broker M can fix a lower rate of interest to be paid by him for the use of Y's money, in fact, that broker M can dictate the terms of the loan and pay such interest as he chooses or no interest at all. If this were so the question naturally arises, why does broker Y ever pay any interest? The answer is that the law of supply and

demand applies to these transactions, as well as to all other ordinary mercantile transactions. As we have said, the broker lending the stock desires the use of the money which he receives upon delivery of the stock to the broker borrowing it.

There are advantages in a "broker loan" which are not found in a bank loan. It is well known that a bank will not lend more than seventy-five per cent. or eighty per cent. of the value of the stocks deposited with it as collateral security. The chief advantage of a broker loan over a bank loan is that the broker who delivers the stock receives the use of money equivalent to the full value of the stock (R. 7). Naturally, therefore, brokers who have surplus stocks of a designated kind are willing, in fact eager, to lend that stock. If broker M is unwilling to lend his stock and pay the prevailing rate of interest on the money received by him, some other broker will. Thus the law of supply and demand, and not the whim of the lender of the stock, regulates the interest rate on transactions such as we are now discussing. It is therefore no more correct to say that M, the broker lending the stock, may decline to pay interest on the money received by him as part of the transaction, than it is to say that any other party to a mercantile transaction may decline to buy or sell or enter into any other contract except on terms agreeable to him.

The agreed statement of facts reflects the foregoing considerations, for it says (R. 7) :

"The broker lending the stock has the use of the money deposited with him while the loan lasts, and pays the broker borrowing the stock interest at such rate as is agreed upon between them from day to day. *The usual rate is about the same as the prevailing rate for 'call loans' of money.*"

The Court below, we respectfully insist, lost sight of the facts, and drew its conclusion, not from the normal and usual

method of lending stocks, but from the abnormal and unusual condition which may sometimes exist and which may make it difficult to procure a loan of stock. Naturally, if economic laws operate among brokers as they do elsewhere, when such a condition arises, the broker who has stock to lend is able to procure an advantage therefrom and he may be able to lend the stock under an agreement calling for the payment on his part of a lower rate of interest than the call money rate, or if conditions warrant, no interest at all. But it must be apparent that when the lending broker is able to secure such an advantage it is by no means because he arbitrarily refuses to pay the current rate, but because in those particular instances there is not the usual free and open market, but an artificially restricted or possibly "cornered" market which makes it possible for the lending broker to drive a harder bargain than he would otherwise be able to do. The opinion of the Court, in so far as it indicates that the rate of interest is always controlled by the lender of the stock, is based upon a complete misapprehension of the real relationship between the two brokers involved.

A careful study of the transaction must lead to the conclusion that whatever differences there are in the mechanism of a bank loan and that of a broker loan are merely differences of form and not of substance.

There is no difference in legal effect between a bank loan and a loan of stock between brokers, for in each case there is, on the one side, an indebtedness payable on demand, and on the other side, a deposit of stock to secure the repayment of the indebtedness.

It is clear from the foregoing discussion that the lending of stock is, not only from the legal standpoint, but also from the practical standpoint, nothing more nor less than a deposit of stock as collateral security for money loaned thereon. The lending broker is actuated by no motive other than that

of borrowing money upon the security of the stocks loaned. The transaction differs in no essential aspects from an ordinary bank loan, and it should, therefore, be held that such a transaction comes squarely within the first proviso of Paragraph IV of Schedule A of the 1917 and 1918 Acts.

CONCLUSION.

To recapitulate briefly, we have indicated that the tax sought to be recovered was wrongfully and illegally collected and our claim is substantiated by numerous considerations. In the first place, an examination of the 1917 and 1918 Revenue Laws in the light of earlier legislation indicates clearly that it was not the intent of Congress to tax the borrowing of stock and the return of borrowed stock. In the second place, the 1921 Revenue Act conclusively shows that there was no such intent and is to be considered as a correction of the erroneous interpretation by the Treasury Department of the 1917 and 1918 Acts.

There is no logical or even arguable ground for suggesting that Congress intended in any manner to discriminate against short sales. The effect of the Revenue Laws, as enforced by the Internal Revenue Bureau, has been discriminatory against short sales and, in fact, has been to a large extent prohibitive.

We have demonstrated that the transactions in question cannot be held to come within the terms of the enacting clauses of those Acts, for the transactions are neither sales nor are they similar to sales nor do they involve the transfer of legal title to certificates of stock.

Congress has expressly provided that the deposit of stock as collateral security for a loan of money is not taxable. We have shown, not only by an analysis of the facts, but also by the statements of recognized authorities, that the lending of stocks, as practiced by the claimants and other brokers, constitutes a deposit thereof as security for the loan of money

and that, therefore, such transactions come clearly within the terms of the provisos exempting them from tax.

Our contentions, we respectfully insist, are fully supported by the highest authorities.

We respectfully urge that the learned Court of Claims erred in dismissing the claim, and that the Court should have rendered judgment in favor of the claimants, for the amount of the claim as filed.

Respectfully submitted,

WILLIAM F. UNGER.

Of Counsel:

CHARLES E. HUGHES

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APPENDIX.**"THE WORK OF THE STOCK EXCHANGE"**

by

J. Edward Meeker (Ronald Press; 1922), pages 89 to 97.

Thus we see that, as operations, margins purchases and short sales are identical with the purchases or sales on credit which are of universal occurrence in every line of modern business, which have on the economic side powerfully and profoundly furthered human progress in the past few centuries, and without which (as even the Bolsheviki in Russia discovered) not merely the luxuries, conveniences, and comforts, but even the barest necessities of life cannot be daily afforded to mankind. It has furthermore been shown that margin purchases and short sales are reciprocal and presuppose each other, for if we cannot sell (or exchange) what we do not possess, we can never buy more of anything than we are able to pay for.

The question then arises whether the economic results flowing from the employment of these methods of purchasing or selling on credit, however legitimate they may be as mere methods, are beneficial or desirable.

In this connection one fact infrequently recognized is that neither margin purchases nor short sales of stocks are necessarily undertaken for speculative purposes. In many cases, where the investor wishes to purchase stocks outright for cash, the broker, who, of course, cannot tell at exactly what price the required shares can be purchased, will probably instruct him to deposit 50 per cent. of their latest price and pay the balance after they have been purchased. Such a practice is essentially a purchase on credit, even if it is not commonly called a "margin purchase" in Wall Street. Similarly, the owner of 100 shares of Steel may desire to sell them at a time when he is in London or San Francisco and his shares are securely locked up in his New York safe deposit box. Under such circumstances he will probably instruct his broker to sell 100 shares of steel short, and cover the short sale on his return to New York by getting his stock from his box and delivering it to his broker. Thus margin purchasing and short selling may be and often are employed as conveniences in what are essentially outright purchases and sales.

Furthermore, were it impossible to buy and sell stocks on credit, the odd-lot dealer, whose business consists of purchasing or selling from 1 to 99 shares of all listed stocks, could not carry on his useful work. The odd-lot dealer is constantly forced to take a long position of stocks in 100's, by purchasing the various

odd lots which customers may sell to him at all times, and to take a short position in 100's by selling customers any number of shares they may wish. Of course the odd-lot dealer ultimately sells in 100-share lots the stock which he has accumulated by his odd-lot purchases, and he ultimately covers his short sale of odd lots by purchasing in 100-share lots. Yet it is obvious that if purchases on credit or short sales were forbidden, the odd-lot dealer could not successfully carry on his considerable and essential business in enabling small investors to sell or purchase readily.

For all the above instances, however, and many others of a similar nature, it is, of course, undoubtedly true that the vast majority of both margin purchases and short sales are made purely for the sake of obtaining a speculative profit through buying at a lower and selling at a higher price. The broader aspects of speculation as an economic phenomenon must be reserved for a later chapter. Speculation will therefore be considered here only in so far as it finds a practical every-day expression through the margin purchase and the short sale.

Every so often some native Solon will obtain a half-column in the papers to declare that stock speculation, particularly that of bears who sell short in the anticipation of declining stock prices, is injuring the intrinsic value of our railroad and industrial companies. Some indignant critics, indeed, openly state that short selling destroys the companies' property, and picture the bear raider as a sinister villain who delights in the ruin of other men's goods by some mysterious means in the stock market. The sheer nonsense of such statements is, of course, apparent to anyone who knows anything at all about stock market transactions—a knowledge which, paradoxically enough, these critics of stock exchange speculation often hasten to disclaim at the outset.

A share of stock is simply a certificate of fractional ownership in the assets and earning power of some corporation. Let us suppose that some bear trader, believing that the shares of a copper company are selling higher than they should, sells enough of these shares short to depress their price temporarily 2 points. By this operation he has not decreased the amount of copper in the company's mines, nor injured its mining or smelting machinery. Neither has he affected in any way the industrial demand for the company's products, nor its earning power. The effect of his short sale has been to decrease for the time being, not the inherent equities of the company but merely the price of its shares, which are only the warehouse certificates to these assets and earning power.

Thus it is apparent that the fundamental and intrinsic value of a given share of stock may be a wholly different thing from the price at which it can be bought and sold in the market at

any given time. If it were easy to determine exactly what the present and prospective value of a given stock was, there would be as little speculation in stocks as there is in bonds. But the prospective earning power of any corporation depends upon so many constantly changing economic circumstances, and the value of its present assets depends upon the steady price fluctuations of so many commodities, that the inherent value of its shares cannot be infallibly determined. The market price of such shares, therefore, is simply a composite estimate reflecting the opinions of the keenest students of industry and finance all over the country. The "bear raider," as he is sometimes picturesquely but rather inaccurately called, may by his short sales depress prices for a time, but he can no more destroy intrinsic values than he can lower the temperature by putting ice on the thermometer bulb.

Every purchaser of a commodity, whether of stocks or of "shoes and ships and sealing-wax," tends to raise the price of that commodity, since he tends to increase the demand for it and decrease the supply of it. Conversely, every seller tends to lower prices by increasing supply and decreasing demand. These laws operate in the establishing of prices utterly irrespective of whether purchases or sales are made outright or on credit. The outright purchaser of 100 shares of Reading tends to raise the price of this stock just as much as a margin purchaser of the same amount, and an outright seller tends to depress its price just as much as a short seller, if they sell the same amount of stock.

But there is this difference, as regards their effect upon prices, between purchases and sales made outright and those made on credit. The outright purchaser tends more *permanently* to increase the price of the stock he purchases, since he usually withdraws for a long period a number of shares from the supply. Also, the outright seller tends more *permanently* to depress stock prices, since in most cases he does not soon buy back his stock. Credit transactions in stocks, however, almost always involve both a purchase and a sale. The buyer on margin must ultimately prove a seller before he can obtain his profit, and for the same reason the short seller in the end must buy stock. Moreover, both margin purchases and short sales must usually be terminated within a reasonably short period lest interest charges and dividends eat up all hope of profits. In consequence, it is obvious that the buyer on margin at first tends to raise prices and later to lower them; and that similarly, the short seller for the time being tends to lower prices, but later to raise them again. Thus a double check is created against the undue inflation of the price above, or the undue depression of prices below, the actual value of any security in which active speculation occurs on the Stock Exchange.

Let us suppose that the actual inherent value of 1 share of United States Steel common stock is really \$100. Should the price of this stock rise to 105—or higher than its value warranted—the margin buyers who had originally bought their stock at lower prices would begin to take their profit by selling at this price. Also, speculators who believed that 105 was more than Steel common was really worth, would sell the stock short. Selling from this double source would soon tend to depress the price of the stock toward its real value of 100.

If, however, Steel common should be selling at 95, these corrective forces set in motion by speculation would also tend to bring up the price nearer to the real value of 100. Previous short sellers would begin to purchase at the low figure of 95 to cover their short sales and obtain their profit, while buyers on margin, encouraged by the belief that the stock was selling under its real value, would begin buying it "for the rise." And this buying, both from the optimistic bulls and the previously pessimistic bears would, of course, tend to lift the price back toward its real value of 100. Thus speculation through margin purchases and short sales normally prevents the wide and violent price fluctuations which would inevitably result if stocks were removed from the price-registering machinery of the stock exchanges.

Particularly in times when panic is threatening does the "short interest"—i.e., the speculators who have sold short and who are waiting to purchase and cover—perform a valuable service to investors by supporting the falling market with their buying orders and thus helping to hold prices up even in the face of disaster. For at such times the investor and margin purchaser become extremely timid and thus the previous short seller, who is under compulsion to purchase and cover his sales, alone enables the investor who must liquidate, to sell his securities.

Writing of conditions prevailing on the New York Stock Exchange at the outbreak of the Great War in 1914, the president of the Exchange at that time made the following statement:

"The conditions on the Stock Exchange when the storm burst, were in some respects very hopeful . . . the unsettled business outlook due to new and untried legislation had fostered a heavy short interest in the market, thereby furnishing the best safeguard against a sudden and disastrous drop. This short interest was a leading factor in producing the extraordinary resistance of prices in New York which caused so much favorable comment during the few days before the closing (of the Stock Exchange). It were well if ill-informed people who deprecate short selling would note this fact."

In the violent price declines which occurred in 1920 in such staple commodities as leather and wool, the lack of just this buying support which short covering provides in the more speculative stock markets, has been forcefully illustrated. Since there was nothing to halt the downward crash of prices for wool and leather, the decline came the more suddenly and violently. In consequence, the fact that there was no short interest in these two commodities resulted in placing in serious difficulties not merely the leather and wool trade, but also those banks which had discounted bills secured by high-priced stocks of these commodities.

In conclusion, therefore, it may be said that the effect of margin purchases and short sales is really to stabilize prices, that this result is beneficial to both buyers and sellers, and that in an economic sense the undue inflation of prices above values is just as dangerous to everyone concerned as their undue depression below values. If, therefore, short selling were prevented, an effective check would be removed from an upward trend of prices which in the long run would be bound to fall again with a crash, while the support to prices which a short interest provides in just such a declining market would also be removed.

The popular misunderstanding and prejudice against short selling of securities is not new. As long as the stock exchanges of the world have existed the short sale has been bitterly condemned, but invariably indorsed, after thorough investigation or painful experience, as a vital and indispensable factor in the maintenance of free securities markets everywhere. As a necessary operation to organized speculative markets it has, therefore, stood that hardest of all tests—the test of time. Short selling was forbidden in England by Sir John Bernard's Act in 1733; yet this law failed to halt the practice, and in 1860 it was repealed. Similar English legislation later adopted to prevent short selling of bank stocks has also been more honored in the breach than in the observance.

Such, too, has been the experience of France. Napoleon I was dissuaded from forbidding it only by his Finance Minister; later on, the French did legislate against the practice only to repeal the law after its futility and harmfulness were clearly shown. The state of New York has tried the same experiment and with the same result; it prohibited short sales early in 1812, only to remove the ban against them in 1858. Last but not least is the example of Germany. In 1896 a stringent regulation of the Berlin Bourse (or Stock Exchange) was undertaken by the government and again short selling was forbidden, to be reinstated by the repeal of this legislation in 1909. But a famous American economist has stated:

"Finally, the effect of interference, increased cost, and legal uncertainty (entailed by this restriction of stock trans-

actions) was to drive business to foreign exchanges and diminish the power of the Berlin Exchange in the field of international finance. The number of agencies of foreign houses increased four or fivefold, and much German capital flowed to other centers, especially London, for investment and speculation. This in turn weakened the power of the Berlin money market, so that even the Reichsbank has at times felt its serious effects."

Indeed, it is far from fanciful to say that to Germany's un-economic legislation concerning her stock and produce markets can in large measure be attributed the economic collapse of Germany during the war, and the profound financial difficulties in which she subsequently found herself.

So long as optimists are more popular than pessimists, buying on margin will doubtless seem to many people a more beneficial operation than short selling. So long as men think on the money rather than the goods side of sales, short selling will doubtless remain more mysterious to the public than margin purchasing. So long as the fallacious benefits of inflation can claim a popular following, while deflation remains an unpopular and misunderstood process, whatever tends to lift prices above values will continue to be generally judged preferable to whatever may depress them below values. And thus, while perhaps human nature will always condemn the short sale, the changeless and unswerving laws of economics will invariably necessitate its employment.

"THE STOCK MARKET"

by

Solomon S. Huebner,

Professor of Insurance and Commerce, University of Pennsylvania (D. Appleton & Co. 1922) pages 41 ff.

Many condemn and few sympathize with the short-seller in the market, because of the belief that it is wrong to sell that which one does not possess; that no economic good is performed by the practice; and that short-selling artificially depresses security prices. To many short-selling seems to be a pernicious practice that ought to be suppressed. They seem to regard short-sellers as a nuisance and a menace, as a group deliberately bent upon injuring the best interests of legitimate investment. In fact, many have urged the prohibition of short sales, and numerous attempts have been made at legislation with this object in view.

A moment's reflection, however, will show that all these conclusions have little basis in fact. These opponents forget that

short-selling is a common practice in many leading kinds of business. The manufacturer is expected by the wholesaler to sell his finished wares at a definite price for some definite future delivery; and to assure the delivery of his goods at a stipulated price and time, the manufacturer expects the commission man or produce broker to sell the raw cotton, grain, metal, etc., for future delivery at a definite price, even before the crop has been harvested or the metal obtained. In fact, it is becoming increasingly clear that American producers, if they are to compete successfully in foreign commerce, must be in a position to enter into contracts for the future delivery of their goods in distant markets, at definite prices, and at an agreed time. To accomplish this purpose, and at the same time eliminate the element of gamble, it is necessary to secure quotations in advance on the requisite raw materials, marine insurance, foreign exchange, and steamship space. As a matter of fact dealers in produce, marine-insurance companies, foreign-exchange dealers, and steamship companies are usually willing to obligate themselves to the future delivery of their commodity or service at fixed quotations, thus enabling the exporter to determine in advance all the primary costs that enter into his venture. Contractors, likewise, in contracting for work at a definite price, are constantly selling labor and materials "short." The general practice of "hedging" on our exchanges by those handling our important staples must also necessarily involve a short sale. In business generally, therefore, short-selling seems to be regarded as a necessary means of insurance against speculative losses. If recognized by all these business interests, it certainly cannot be maintained that it is wrong in the stock market to sell something that one does not now possess but intends to buy later.

Critics are also wrong in contending that short-selling does not perform an economic good, and that it actually depresses the prices of securities. The short sale in the stock market, and the same is also true of produce markets, is often the greatest benefactor in repressing rampant speculative enthusiasm on the one hand, and in checking the effect on security prices of excessive pessimism on the other. Short-sellers do not determine prices. By selling they simply express their judgment as to what prices will be in the future. If their judgment is wrong, they will suffer the penalty of being obliged to go into the market and cover their sales at higher prices. In making their sales they are just as open-minded in their reasoning as those who purchase because they believe the market will advance. With few exceptions their motive is not a malicious one. They simply hope to make a profit by correctly interpreting the market bearing of economic and political events.

Nine-tenths of the public, it is said, are by nature "bulls" and the higher prices go the more optimistic and elated they become.

If it were not for a group of short-sellers, usually greatly in the minority but, as a class, superior in intelligence, who resist an excessive inflation, it would be much easier than now to raise prices through the roof; and then when inflation becomes apparent to all, the descent would be abrupt and likely unchecked until the basement was reached. The operations of the "bear," however, make excessive inflation extremely expensive, and likewise tend to prevent a violent smash, because the short-seller, to realize his profits, must become a buyer for amounts equivalent to his sales. The writer has been told by several members of the New York Stock Exchange that they have seen days of panic when practically the only buyers, who were taking the vast volume of securities dumped on the Exchange were those who had previously sold short and who now turned buyers as the only way of closing their transactions. They were curious to know what would have happened in those panic days, when everybody wished to sell and few cared to invest, if the buying power had depended solely upon the real investment demand of the outside public. In such times of distress the short-seller becomes, as he has well been called, "the market's best friend." The "bull," it is true, will help the situation with his purchases. But the short-seller renders the *double service* of retarding an unwarranted advance by his sales and of checking an unwarranted decline by his purchases.

In reply to the prevalent opinion that short-selling unduly and artificially depresses security prices, it should be stated that short-sellers are frequently the most powerful support that the market possesses. It is an ordinary affair to read in the daily press that the market is sustained or "put up" at the expense of the "shorts," who, having contracted to deliver at a certain price, can often be easily driven to "cover." Short-selling is thus a beneficial factor in steadying prices and obviating extreme fluctuations. It constitutes a stabilizing force in the market at all times. Largely through its influence, the discounting of serious depressions does not take the form of a sudden shock or convulsion, but, instead, is spread out over a period of time, thus giving the actual holder of securities ample time to observe the situation and limit his loss before ruin results. Indeed, there could be no organized market for securities, worthy of the name, if there did not exist two sides, the "bull" and the "bear." The constant contest between their judgments is sure to give a much saner and truer level of prices than would otherwise exist. "No other means," reports the Hughes Committee for the investigation of exchanges, "of restraining unwarranted marking up and down of prices has been suggested to us."

The usefulness of short-selling is by no means limited to the discounting of important events that affect the market, to the resisting of excessive inflation of the general price level of the

market as a whole or of the price of any particular security, to the checking of unwarranted declines in times of panic and business depression, and to the steadying of prices by causing declines or advances to be gradual instead of violent. These general functions of short-selling are supplemented by a large number of specific uses, each of which fills a distinct economic need, and all of which, considered collectively, make an organized market much more serviceable to the community than otherwise would be the case.

"THE STOCK EXCHANGE FROM WITHIN"

by

William C. Van Antwerp

(Doubleday, Page & Co., 1913) pages 84 ff.

To the farmer, the politician, and the layman generally, short sales of cotton or grain are understood, approved, in fact, if the grower happens to be the one who profits by them. But substitute stocks and shares for wheat and cotton, and talk of "operations for a fall," and the layman thinks he smells a rat. He sees the bale of cotton or the carload of wheat actually moving; it is a concrete thing; it appeals to his senses, it is comprehensible. But talk to him of bits of paper called stock certificates, and by a curious process he concludes that a short sale has no basis of reality and is therefore menacing and improper. He persuades himself that short selling ought to be prohibited by law, and, since Wall Street harbors the chief offenders, he finds in the nearest politician a handy ally to assist him. These gentlemen, who obstinately refuse every other medicament, could be cured of their ailment by a strong diet of economics. They become subjects of medical, rather than financial, interest. They should dip themselves into Conant and Leroy-Beaulieu; they should cool off in the pages of Bagehot and Emery; and, by the time they have got into the soothing columns of the Hughes Commission's report, they will be ready for new points of view.

As a preparatory lesson: suppose a speculator buys from a commission merchant a carload of coal of a specified grade. The coal is not in the possession of the commission merchant, but he knows where he can get it, and he knows that he can deliver it on the date agreed upon. Accordingly he sells it short, and enters into a binding contract which, happily, the courts construe to be perfectly legal. Now suppose the same purchaser wishes to buy 100 shares of Pennsylvania Railroad stock. All Pennsylvania stock is the same, that is to say any 100 shares of it is

just as good as any other 100 shares of the same property—the number on the certificate is of no importance whatever.

The dealer to whom he applies does not happen to have 100 Pennsylvania on hand, but he knows where he can get it, and he knows that he can deliver it to the purchaser on the following day. So he sells it short, and all that remains to complete his part of the contract is the actual delivery. He is then a bear on Pennsylvania stock. He may, if he chooses, go into the open market and buy the stock at once, so that he will be able to deliver it in the easiest and most direct way. Or he may feel that by waiting he may be able to buy at a lower price than that at which he has sold it, hence, in order to make the delivery promptly, he borrows the hundred shares from one of his colleagues, to whom he pays the market price as security for the temporary loan of the certificate. In a day or two the price of the stock may have declined, whereupon the bear goes into the market and buys the 100 shares of Pennsylvania at a price, say, 1 per cent. lower than that at which he sold it.

When this certificate is delivered to him next day, he delivers it in turn to the man from whom he borrowed the original 100 shares; his security money is then returned to him, and the transaction is closed. It is just as real a transaction as any other, and just as legal. Moreover, since it is always possible to buy, but not always possible to sell, the active presence in the market of large numbers of bears who *must* buy, whether they want to or not, is the very best policy of insurance that a holder of securities could have.

Many years ago there was a law on the French Statute books, subsequently repealed, prohibiting short sales. M. Boscary de Villeplaine, a deputy chairman of the association of stockbrokers, was conversing with Napoleon regarding a pending discussion in the Council of State looking to the repeal of the law. "Your Majesty," said de Villeplaine, "when my water carrier is at the door, would he be guilty of selling property he did not own if he sold me two casks of water instead of only one, which he has?" "Certainly not," replied Napoleon, "because he is always sure of finding in the river what he lacks." "Well, your Majesty, there is on the Bourse a river of Rentes."

Napoleon felt, no doubt, that there was something inherently wrong in selling short; even as these lines are written, counsel for a Congressional committee is attempting to make witnesses admit that the practice is "immoral." But why, where, how is it immoral? It pervades all business; no question of morals or ethics enters into it at all. The man who sells you a motor-car has not got it; he accepts your money and enters into an agreement to deliver the car next spring because he knows or believes that he can make it and have it ready for delivery at that

time. Meanwhile he has sold short. A gentleman of my acquaintance has sold thousands of storage-batteries on the same basis, although plans for them have not yet been designed to meet the specifications. At Cape Cod the cranberry-growers sell their crop before it has begun to mature; all over the land contractors and builders are "going short" of the labor and materials which, at some time in the future, they hope to obtain to fulfil the terms of their agreements. Are all these worthy people "immoral"?

If it is immoral to *sell* for a purpose, it is equally immoral to *buy* for a purpose; in each case the purpose is the hope of a profit. Buying for a profit is approved by every one; why not selling? In both instances you have bought or sold for a difference in price; the *sequence* of the events in no way involves a question of morals, since there is no ethical difference and no economic difference between buying first and selling last, and selling first and buying last. Moreover, in selling short you do no injury, since you sell to a buyer, at his price, only what he wants and is willing to pay for.

All suggestions of impropriety in short selling are grotesque in their absurdity. But suppose, for purposes of argument, that economic errors of some sort were actually involved in this practice. How could it be regulated or controlled? As the governors of the Stock Exchange stated to the Hughes Commission in 1909, short selling is of different descriptions. There is the short sale where the security is held in another country and sold to arrive pending transportation. There is the short sale where an individual sells against securities which he expects to have later, but which are not in deliverable form; and in this connection I call your attention to the recent sale of \$50,000,000 of Corporate Stock of the City of New York where deliveries were not made for a period of about three months, and which stock was dealt in enormously, long before it was issued.

"If a market had not been provided for it under those conditions," said the governors, "the loan could not have been placed. Then, again, there is the short selling of stock against which different and new securities are to be issued; the vendor knowing that he is to receive certain securities at a distant date, but desiring to realize upon them *at this time*. Beyond this, there is the regular selling of short stock, either by parties who do so to hedge a dangerous position upon the long side of the market, or the sale purely and simply with the intention of rebuying at a profit, should circumstances favor it."

Finally, there is the investor with stock in his strong-box actually paid for and owned outright. He may wish to sell in a strong market with the hope of repurchasing at lower prices, but for reasons of his own he may borrow the stock for delivery rather than deliver the securities bearing his own name. Tech-

nically he is short; he is a bear. But in his case, as in that of the others here cited, how can this perfectly proper method of doing business be "regulated" or interfered with in any way? I do not think it necessary to pursue so palpable an absurdity.

It has been said that the bears often resort to unfair methods to bring about declines in prices, circulating rumors designed to alarm timid owners of securities and thus frighten them into selling. That this is done every now and then is undeniable, but the opportunity of the bear in these matters is very limited, and may be easily and speedily investigated, whereas similar practices by the bulls in inflating values by all sorts of grotesque assertions and promises are by no means so easily run to earth, and do incalculably more harm.

The bear who drags a red-herring across the trail now and then interrupts the chase, but he cannot stop it; the genial optimist who has a doubtful concern on his hands, with a pack of enthusiastic buyers in full cry at his heels, is a much more serious matter. Good times and bull markets engender many questionable practices of this sort. "All people are most credulous when they are most happy," says Walter Bagehot; "and when much money has just been made, when some people are really making it, when most people think they are making it, there is a happy opportunity for ingenious mendacity. Almost everything will be believed for a little while, and long before discovery the worst and most adroit deceivers are geographically or legally beyond the reach of punishment. But the harm they have done diffuses harm, for it weakens credit still further."

If this book were written for people instructed in economic matters there would be no occasion to dilate upon the usefulness of bears and the value of short selling, but since we are addressing laymen who do not understand how the bear can be a useful factor, we may venture to say once more that insurance is the chief advantage in his operations. Ex-Governor White's contribution to the subject, which I have quoted in this chapter, is strongly supported by Mr. Conant, who shows that valuable progress in opening new countries and developing new industries is often made possible by "bearish" operations designed to "hedge" or insure the new undertaking against loss.

"The broker who has a new security which he desires to place from time to time in the future, making possible, for instance, the opening of a new country to railway traffic, protects himself against loss resulting from future changes in market conditions by selling other securities for future delivery at current prices. These securities will realize a profit when the date arrives for delivery if the market has in the meantime become unfavorable, and will offset the loss upon his new securities. They will have to be bought at a loss if the movement of prices has been upward,

but the upward movement will afford a profit upon the new securities which he is seeking to place upon the market. Thus, to quote Georges-Levy, 'there is a genuine insurance, which the broker will have himself organized and on which he will willingly pay the premium for protection against any accident'."

An instance such as this serves to show the difference between gambling and speculating, terms that are often misapplied by critics of stock markets. A gambler seeks and makes risks which it is not necessary to assume, and which, in their assumption, contribute nothing to the general uplift. But the speculator—in the instance just cited, a bear who sells short—volunteers to assume those risks of business which must inevitably fall somewhere, and without which the mine, or the factory, or the railroad could not be undertaken. His profession, and the daily risks he assumes, call for special knowledge and superior foresight, so that the probability of loss is less than it would be to others. If he did not do it—if there were no bear speculators—the same risks would have to be borne by others less fitted to assume them or the useful projects in question would not be undertaken at all.

So general is the employment of these hedging or insurance operations that in the case of cotton—to cite but one instance—the business is regarded by practically all cotton merchants as an absolute necessity under modern methods of conducting business. "An idea of the value of the hedging function may be obtained," says Herbert Knox Smith, Commissioner of Corporations, "when it is stated that in Great Britain banks very generally refuse to loan money on cotton that is not hedged. Moreover, it is almost universally conceded that, since the introduction of hedging, failures in the cotton trade, which had previously been frequent, have been materially reduced as a direct result of the greater stability with which transactions in spot cotton can be conducted."

In conclusion it may be noted that as early as 1732 an attempt was made in England to prevent short sales by law, that the law was recognized a mistake and subsequently repealed. To-day there is no law on the English Statute books restricting speculation in any form. In America the New York State Legislature enacted a law in 1812 and the Federal Government in 1864, both designed to prevent short selling. These laws have also been repealed and they will not be revived. The bear has come to stay. As a spectre to frighten amateurs, he may continue for a time to stalk abroad o' nights; as a necessary and useful part of all business he is a substantial reality. And he is not "immoral."